ECONOMIC PROBLEMS OF MODERN LIFE

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ECONOMIC PROBLEMS OF MODERN LIFE

To

EMORY R. JOHNSON

FORMER DEAN OF THE WHARTON SCHOOL

PREFACE TO THE FOURTH EDITION

The Second World War delayed this revision of "Economic Problems of Modern Life." Both authors were busily engaged with many emergency tasks off campus and with accelerated educational programs on campus. Moreover, the ephemeral character of many economic innovations necessitated by the Second World War indicated the desirability of further postponement of revision until a "return to normalcy" should give a clearer perspective for a better evaluation of important trends than was possible during a period of rapid readjustment.

Significant economic changes during the past decade necessitated a complete rewriting of the material covered by this book. Nevertheless, the original plan of development has been retained. The same general topics have been treated in about the same order and with similar allocation of space. The introduction, which has been subdivided into two chapters, will be useful to those students who have had no previous work in economics, but it may well be omitted by others who have had a basic course in principles.

The first half of the text is concerned primarily with pecuniary problems of business; progression therein is from domestic to foreign exchange and from private to public finance. The second half of the text is devoted to broader problems of social economics; progression herein is from land economics through problems of capitalistic organization, those of labor and the national welfare, to international programs and developments. The final chapter on the Soviet economy is somewhat specialized; it may be used if time and interest permit its consideration.

Each chapter has a set of guide questions on the text, based on material covered therein, and designed primarily for review; they seek to promote thinking and to provide discussion. Each chapter, furthermore, has a list of topics for investigation; they include suggestions for special reports, oral or written, which may motivate individual students to intellectual activity beyond a mere mastery of the class assignments in the text. Also at the end of each chapter are a few carefully selected references to more specialized books in that particular area. Finally, it is hoped that continual and intelligent use will be made of newspapers and periodicals by

all students to keep them informed of important contemporary developments in economic problems of modern life.

Each author has read carefully the work of his colleague in order to achieve unity and coherence in the volume as a whole. Nevertheless, Mr. Patterson is primarily responsible for Parts One, Two, Seven, Eight, and Nine; and Mr. Scholz, for Parts Three, Four, Five, and Six; Part Ten is a joint product.

The authors desire to express their appreciation of the sympathetic encouragement and constructive criticism given them by Drs. William N. Loucks and W. C. Plummer, Professors of Economics at the University of Pennsylvania. They are indebted also to Mrs. Carol K. Scholz and Carol Frieda Scholz, who aided in reading proof and preparing the index.

S. HOWARD PATTERSON
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PHILADELPHIA, PA.
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FROM THE PREFACE TO THE FIRST EDITION

"Economic Problems of Modern Life" is another text in economics. The authors have endeavored to prepare a book which may be used either as the basis of a course in economic problems or as supplementary problem material to the traditional first course in principles. Although there are a number of good books on economic principles, and on economic principles and problems combined, at the present time there are not many available texts which are devoted specifically to the study of present-day economic problems.

Businessmen, in their everyday activity, are confronted with economic problems rather than with theoretical abstractions. They are forced to learn their economic principles by contact with practical business problems. In the case of the college student, however, this situation does not usually hold. Although progression from the concrete to the abstract is an old maxim of pedagogy, most courses in economics reverse this process by beginning with a study of principles and by concluding with an analysis of as many practical economic problems as time permits. It may be, however, that a systematic study of economic theory can best be made after the student has completed a survey of some outstanding problems of our economic life. Certainly an analysis of economic principles necessitates some knowledge of the complexities of our economic organization.

Although this book is primarily concerned with economic problems, in striving to increase its usefulness the authors have been forced, incidentally, to introduce economic principles into their discussions. Just as economic theory cannot be kept in a vacuum, so a study of economic problems would be of little educational value without some attempt to discover the underlying principles which are involved. Moreover, in order to give unity to the text, some material has been introduced which may be found in books on principles of economics. Most of this material is contained in Part One, the inclusion of which is essential for students who have not had previous training in economics. It can be omitted in classes which have previously gone through one of the orthodox texts on economic principles.

Since any reading in economics is merely a start for one's own thinking, it is hoped that the questions for discussion at the end of each chapter will

aid the student in assimilating his assignment. The topics for investigation are suggested by the text material and may be found helpful for supplementary work. In the collateral reading, listed at the end of each chapter, specific assignments pertaining to materials contained in the text will be found. A certain amount of collateral reading and the systematic keeping of reading notes will be found helpful. The student should be encouraged to obtain a broad perspective of the subject by reading other authors with different points of view. In the references are listed more advanced and specialized treatises in the various fields of applied economics, which are only surveyed in such a general text as "Economic Problems of Modern Life."

S. Howard Patterson
Karl W. H. Scholz

Philadelphia, Pa.
January, 1927

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CHAPTER I

FUNDAMENTAL CONCEPTS AND CHARACTERISTICS OF MODERN ECONOMIC LIFE

A. THE STUDY OF ECONOMIC PROBLEMS

1–1. Nature of Economics. Economics may be defined as the social science of business or as the general study of man's efforts to get a living. Economics is social in character, because it is concerned with the prosperity of the whole group. Accounting, on the contrary, studies the financial standing of individual firms, as indicated by proprietors' balance sheets of assets and liabilities and by their profit and loss statements. Economics, however, is general in its scope, covering the entire area of business. It is subdivided into fields of specialization, such as finance, marketing, insurance, and industrial management.

Economics may be defined also as the social study of wealth and welfare or merely as the social science of wealth. Economic wealth is material and objective. It includes all those things having materiality, utility, scarcity, and transferability. As economic wealth is definable and even measurable in markets through the mechanism of money prices, there can be a social science of economics, if it is so restricted in scope. Welfare, however, is subjective, indefinable, and immeasurable. Important though it is as a social study, an analysis of welfare lies outside the narrow borders of science; it falls within the broader realms of ethics, on which politics, sociology, and applied economics must trespass.

Finally, economics can be regarded as the study of pecuniary values, or the price aspects of those commodities and services called economic goods. The chemist analyzes the physical properties of matter and the philosopher describes the aesthetic qualities of an object of art. The economist, however, seeks an explanation of its exchange value or price through an investigation of the determining factors of supply and demand.

1–2. Pure and Applied Economics. The scientist, the technologist, and the moralist can be distinguished one from another by the following simple example. The scientist examines a substance, which he discovers to be a powerful poison. The technologist then seeks its various uses and computes its effectiveness in these different ways. The moralist, finally, deliberates on the great social issue as to whether or not such an effective poison should be used for gas warfare in a national emergency.

The aim of pure science is not the immediate utilization of its findings for specific ends, but rather the discovery of truth for its own sake. Its ultimate objective is the formulation of a coherent body of correct and consistent principles from a careful observation of facts, an accurate measurement of tendencies, and an objective comparison of differences, from which data classifications and generalizations can be attempted. Pure economics, for example, seeks to describe economic processes and to discover basic economic principles; it does not prescribe economic policies or formulate economic programs. Its primary purpose is to explain, not to justify or to modify, the economic order. Pure economics, like true science, recognizes no right or wrong except in the sense of validity or error. It confines itself to definable economic wealth as measured in the laboratory of the market place; hence it is called price economics, sometimes in contrast to welfare economics.

Pure economics, a study of principles and prices, is ordinarily divided into the four related divisions of consumption, production, value or exchange, and distribution. Applied economics, on the contrary, considers economic programs and compares economic policies; it seeks industrial progress. Applied economics includes various clusters of economic problems, such as those of domestic and foreign trade, of private and public finance, of land utilization and capitalistic organization, of labor relations and industrial management, and of national and international prosperity. A study of economic problems is essentially an excursion into applied economics.

Applied economics depends on pure economics, for a good solution of economic problems involves economic principles. Thus, a sound tariff policy is conditioned by a comprehensive knowledge of international trade, and an intelligent discussion of minimum-wage laws requires a mastery of theories of wages. Although there will be differences of opinion as to how the economic welfare of a group can best be advanced, a knowledge of fundamental economic principles is essential. "What is" must be known before "what ought to be" can properly be considered.

Applied economics involves ethical and subjective elements, for here moral choices and individual judgments are necessary. Questions of policy are raised, and the benefits and dangers of one solution must be balanced against those of another. Pure economics, for example, describes how the interest rate is determined and how commodity prices are established under certain assumptions and within a particular set of institutions. Applied economics, in contrast, considers whether or not interest should be paid and how competition should be preserved and monopoly prevented. What are the alternatives? Which of them seems best, and how can it be secured?

Applied economics suggests social control and political planning. But there is no general agreement as to what constitutes social welfare and how best it can be achieved. Most people view social welfare from their own limited, individual viewpoints; they are apt to construe social progress in terms of their own vested interests. History records the continuous clash of conflicting ideas of competing leaders concerning divergent aims and different means of securing similar objectives. But individual judgments, of which public opinion is made, should be informed and independent, intelligent and conscientious, even though they are subjective speculations reflecting different personal attitudes toward the same issue. Hence, the study of applied economics is neither foolish nor futile.

1–3. Economics in Relation to Other Social Studies. Ways of getting a living depend on the physical environment of the group; they are conditioned by its natural resources and location. Hence, some knowledge of geography is basic to the study of economics. Modern industrial organization is also the result of past inventions and continuous improvements. Therefore, history, which traces man's social development and explains the origin of his present institutions, is equally fundamental to economics.

The business of getting a living is now a collective or corporate process of individuals working together in cooperation or competition with each other in interdependent communities. Hence economics is social in character and thereby related to sociology. The study of economics centers about industrial techniques or ways of getting a living, while the supplemental subject of sociology studies ways of living as expressed in social institutions. Anthropology, on the other hand, despite its broad title, is concerned chiefly with the culture of primitive peoples, as represented both by their ways of living and by their ways of getting a living.

The complexity and interdependence of modern industrial society have compelled governments, as we shall see, to assume many functions, such as the regulation of public utilities and the supervision of working conditions. Today, the state is one of the most powerful of all social institutions. It is the chief agency for the social control of industry. Hence, economics, especially applied economics, is closely related to political science and jurisprudence. Indeed, economics was formerly called political economy or national housekeeping.

Economics and the other social studies developed from moral philosophy, just as the physical sciences grew from natural philosophy, the other twin daughter of the great mother philosophy. Ultimate aims and various means of achieving them will always involve ethics. Valid methods of reasoning, without which scientific instruments are worthless, still require logic. As economics is the study of man in the business of getting

a living, and not merely of the business of getting a living, it needs psychology, as well as ethics and logic. Knowledge of human behavior is essential to an understanding of motives and choices in consumption and to the formulation of effective incentives to increased and improved production.

1–4. Origin of Economic Problems. Economic problems arise from man's attempt to make a living and to secure for himself more and better economic goods, *i.e.*, those commodities and services which are not supplied free by nature and which have utility to gratify human wants. Primary factors in this economic drama are man and his environment, *i.e.*, labor and land. Secondary factors are accumulated capital, such as tools and machines, and acquired knowledge of better techniques of production. The motivating force is the insatiable character of human wants. Economic consumption furnishes a continuous drive toward increased and improved production.

The origin of economic problems then lies in the infinity of human wants in contrast to the meagerness of economic goods with which to appease them. This scarcity of economic goods, in turn, is due to the niggardliness or resistance of nature, to man's limited knowledge, and to his own lack of endurance or dislike of work.

Hence, there arises a threefold conflict: (1) out of man's struggle with his environment, (2) out of man's competition with his fellow men to secure for himself a greater share in the good things of life, and (3) out of man's internal struggle in his own mind between the penny or the cake and between luxury or leisure.

Nature does not supply its gifts in unlimited abundance or in finished form. If we lived in a paradise, where all consumers' goods were supplied without effort or limit, there would be no necessity to struggle either with our environment or with our fellow men. But, since ours is not a utopian world, economic goods are scarce and human labor is necessary. Invention of machinery and improvement in the arts of production, however, have eased the primitive struggle of man against his environment.

Economic problems arise not only out of man's struggle with his environment, but also out of man's struggle with his fellow men. The conquest of nature has not produced social harmony, and technological progress has not brought peace to the souls of men. Human wants have increased even more rapidly than our ability to gratify them. A relative scarcity has continued in spite of increasing wealth. From it has arisen a conflict of interests between men. Primitive tribes fought for good land as modern nations do for gold and oil. Within the group a similar clash between the "have" classes and the "have not" masses has persisted. Hence, society has been forced to intervene in the struggle for existence, in order to change it from military conflict to peaceful competition. Forms

of competition must be regulated, for the business of getting a living should be productive and not predatory.

Finally, there is the struggle within an individual's own mind between work and wealth, between spending and saving, and between keeping for himself and sharing with those he loves. Consumption itself is a matter of individual conflict between one's back for clothes and one's stomach for food, or between desires for a new house and a new automobile.

1–5. Economy of Multiple Wants and Scarce Means. Increased ability to gratify human wants results merely in a further increase in economic wants. This limitless expansibility of human wants can be seen in the evolution of economic society as a whole and in the expenditures of individuals with increasing incomes. Indeed, the progress of society and the success of people are marked by increased consumption and improved production, *i.e.*, by more wants and by better means of gratifying them.

This fundamental and interrelated process of increased consumption and improved production will continue as long as economic man is stimulated by his expanding wants to improve means of gratifying them by his own ingenuity and industry. It will always be necessary, however, to economize, *i.e.*, to make the best use of scarce means for alternative uses.

Stoics approached the central problem of human happiness subjectively; they taught that the suppression of material wants through self-discipline was the philosophical ideal. Ascetics similarly suppressed economic wants and stressed spiritual ideals; happiness through self-indulgence was an obstacle to salvation. Modern economists, however, approach this same problem more objectively through external factors and material means. They accept human nature and assume economic wants, which they seek to gratify better by increased production and improved consumption.

1–6. Persistence of Economic Problems. Despite the fluidity of our economic life, many of its problems are hardy perennials, which flourish in ever-changing forms from age to age. Agrarian questions, for example, have continued to vex statesmen from the Roman Gracchi to Henry George. Again, the problem of monopoly has persisted, even though its character has changed. Other problems have come and gone, but the stream has been continuous. History never repeats itself, at least not in exactly the same way, but it does afford interesting analogies.

In his long economic evolution man has progressed gradually from a primitive and self-sufficient economy of scarcity to a complex and interdependent society of relative abundance, characterized by markets and machines, luxuries and leisure. As our economic organization has become more intricate, new problems have arisen because of this increased complexity of society and the multiplicity of choices that it presents. A com-

parison of modern industrial society with what it was before the Industrial Revolution is like the contrast between a high-speed automobile and a primitive oxcart. The latter is much slower and less comfortable, but it is more simple and less dangerous.

Modern economic society has a highly organized system of industry and trade, which permits great specialization, but which also necessitates grave interdependence. Roundabout or capitalistic production has enhanced the world's wealth, but it has also increased the probability of misdirected production and the menace of unemployment. Progress has its costs as well as its benefits.

Progress also raises social ideals and economic standards, a fact that obscures the progress made toward them. Hence, there persists the general problem of culture lag between needs and deeds, between actualities and potentialities, because rational men suffer continuously from sublime discontent with existing conditions. Ordinary men find economic problems in their conflicts of interests and their dilemmas of choice.

1–7. Solution of Problems. An economic question differs from an algebraic problem, which has a definite solution, even though there may be more than one answer. To an economic question there is usually no one correct answer that excludes all others as incorrect. There are generally several ways out of a difficult situation, each of which has its advantages and its corresponding disadvantages. Since most proposals contain the good and the bad, the desirable and the undesirable, the student generally faces a choice of alternative solutions. Again, economic problems are frequently so related that what seems to be a favorable solution for one problem may cause a maladjustment in some other economic situation, just as in medicine a drug which cures one disease may induce another difficulty, and thus be of doubtful help to the suffering patient.

An economic problem is complex because it involves many elements, some of which are neither measurable nor comparable. In the first place, it is as difficult as it is necessary to get the essential facts at issue. In the second place, the relative advantages and disadvantages of each proposed solution must be weighed against each other, so far as they are discernible and measurable. Finally, careful judgment is involved in making a wise choice; but decisions must be made, if a policy is to be prescribed and if a program is to be formulated. Indeed, economic training involves not only research methods for getting relevant data, but also critical and constructive ways of interpreting them for the proposed solution of particular problems.

1–8. Plan of Text. The study of economic problems is frequently disappointing to the beginner who is seeking definite answers to the many questions continually perplexing him. It must be admitted at the outset that this text does not have all the answers. It seeks to state the prob-

lems at issue carefully, to break them down into their component parts, and to appraise the several proposed solutions. After a review of the chief expedients suggested and a brief analysis of the comparative advantages and disadvantages of each, the student is left free to make his own choice.

This text, for example, will make out a case neither for free trade nor for protection, neither for the open shop nor for the closed shop; it will present the arguments on both sides as objectively as possible. After presenting the pros and cons of many current programs, however, practical policies will be indicated that may be adopted to correct gross economic maladjustments. The fact that an economic problem has not one true answer, but several possible solutions should prevent dogmatism on the part of teacher and student alike. It should engender a critical tolerance of all objective viewpoints and a spirit neither of hostility nor of futility.

Because of the close relationship of economics to sociology and political science, it is not easy to single out certain problems of our national life and to say that they are economic rather than social or political. The study of labor problems, for example, crosses all three of these adjacent fields of knowledge. From a wide range of pressing issues, only those problems whose economic aspects seem most striking have been selected for inclusion in this text. All of them are interrelated, and each has social effects and proposed remedies in political action through legislation.

Applied economics, as previously observed, can be broken down into the study of several groups of related problems. The first half of this text will emphasize the pecuniary problems of society. Part One, consisting of two introductory chapters, will be followed by Part Two, with three chapters on basic problems of our general business organization. Problems of domestic exchange will be treated in Part Three; those of foreign trade, in Part Four; and those of public finance, in Part Five. It will be observed that the progression is from domestic to foreign exchange and from private to public finance.

The remaining five parts of the text, comprising roughly the second half of the book, will feature social economics. Here the progression will be from problems of land economics to those of capitalistic organization, and then to those of labor and social welfare. Problems of national well-being will be followed by those of world economics, and programs of industrial reform by those of industrial reorganization.

1–9. Economic Panaceas. Economic panaceas resemble widely advertised patent medicines that claim to cure all physical ills. The student will do well to avoid such nostrums in his search for the best answer to an economic problem. The good physician is a careful diagnostician, in contrast to the medicine man selling cure-alls from a soapbox.

Economic problems are discussed in modern society with the same fervor that characterized the medieval arguments on theological questions. The street corner, the club, the barber shop, and the dinner table produce glib speakers, if not deep thinkers. The bootblack who shines one's shoes will meanwhile rant about the injustice of a higher streetcar fare, although he is probably unable to answer intelligently a single question on utility valuation and rate making. The commuter may express his vigorous advocacy of, or his violent opposition to, public ownership of utilities, without any adequate and accurate information on that subject.

The amateur would be less likely to make such superficial judgments in the fields of the physical or biological sciences; he would be more apt to leave to the medical expert an inquiry into the causes of cancer and the efficacy of radium treatment. There is just as great need for adequate knowledge and disciplined thinking in the social studies as there is in the natural sciences. But many so-called "economists," both amateur and immature, have not developed a scientific attitude, which impels them to secure facts and to reason without prejudice or passion. Only in such fashion can one reach sound conclusions or make an intelligent choice.

1–10. Approach of Student. One should approach a problem in economics with an open mind. In its quest for truth, science demands of the thinker that he be unprejudiced in his search for, and analysis of, the facts in the case. But ignorance and bias are as common as they are inseparable. An impersonal attitude is difficult to attain because our feelings run high when we discuss problems associated with private property. Self-interest tends to produce an emotional, not an intellectual, reaction. It is difficult to substitute the cold light of reason for the blinding heat of passion.

Every individual has so thoroughly assimilated the social institutions of his group that they have become a part of his being, thinking, and feeling. One accepts the social attitudes of one's parents as subconsciously as one receives one's biologic heredity. Our "own" opinions are really a complex of those of our family circle, our church, our school, our club, and our social group. Hence, it is difficult to be impersonal and objective, even when one makes a conscious effort to become so.

Sewell Avery, official of Montgomery Ward & Company, and Philip Murray, officer of the Congress of Industrial Organizations, are the products of contrasting backgrounds. Without impugning the intellectual honesty of these two industrial leaders, it is not difficult to see how each approached from an opposite pole the subject of collective bargaining, and how each viewed from totally different angles the moot question of the open, versus the closed, shop.

The student should begin his study of economic problems with the scientific attitude of intellectual curiosity; he should be prepared to dig for facts, to sift the evidence, and to follow the argument wherever it may lead. Personal prejudices and preconceived opinions must be laid aside; snap judgments are to be discouraged and easy solutions to be viewed with suspicion.

In the following treatment of economic problems, the student will be dealing with highly controversial questions. The vested interests, *i.e.*, selfish considerations opposing changes or seeking special benefits, often confuse issues and thwart social progress. Economic nearsightedness will obscure the arguments of those on the other side of the question. One must strive continually and consciously to get the "other fellow's point of view" in addition to his own attitude. Truth may lie between these two extremes. The real facts may be buried far beneath superficial and erroneous opinions.

This difficulty occurs with less frequency or severity in the physical sciences. The student in chemistry who drops a piece of zinc into a test tube of hydrochloric acid will obtain hydrogen in whatever university the experiment is performed; the result will be the same whether he is a Caucasian or a Negro. The human equation, however, is apt to project itself into the analysis of social or political issues. Thus, economic problems, which have to do with wages, taxes, and the high cost of living, touch a man's personal interest very closely; he is tremendously concerned with them, for his comfort and happiness are thereby affected. Even a scientist seeking to investigate economic problems with an impartial detachment must eat, buy clothing, and keep his job. It is much easier to observe the generating of hydrogen with a scientific aloofness than it is to contemplate the rising cost of foodstuffs or the prospect of a trolley strike.

The scientific attitude substitutes solid fact and sound reasoning for uninformed opinion and personal prejudices. Although economists are on the intellectual firing line, the position of the true student should be above the smoke of battle where he can get a clearer picture and a better perspective than in the midst of heated controversy.

B. ECONOMIC EVOLUTION AND ORGANIZATION

1–11. Capitalism. The term "capital" is used to refer to a particular type of economic wealth, *i.e.*, the products of past labor used in further production. The term "capitalism," however, refers to a social system in which capital plays an important role. Capitalism involves certain economic institutions, chief among which are individual enterprise, private property, freedom of contract, competition, the profits motive, and automatic price regulation of business. It is a pecuniary system of rugged

individualism and freedom of choice. Capitalism also implies commerce and the existence of merchants, markets, money, credit, and other financial institutions of exchange.

The Commercial Revolution marked the transition from the local subsistence economy of the medieval manor to the modern exchange economy of world trade. The birth or rebirth of capitalism took place in the Renaissance cities of northern Italy, such as Venice, Genoa, and Florence. It was expressed in the rise of towns and the revival of commerce following the Crusades. The self-sufficiency of the feudal manor was expanded into the national economy of mercantilism. Serfdom, a caste system with payment in kind, was superseded by a free peasantry with monetary rents and wages. The discovery of America brought increased wealth and opportunity; it expanded markets and improved methods of trade. As the Mediterranean world became oceanic, the local guilds were supplanted by national trading companies, such as the British and the Dutch East India Companies.

1–12. Industrialism. Industrialism is a later phase of capitalism, which developed after the Industrial Revolution. Whereas capitalism is a pecuniary system of free enterprise and private profits, industrialism is a technological concept suggesting enlarged units of manufacture and greater powers of production through the invention of machinery. Industrialism can exist in a country that has repudiated capitalism because it involves economic techniques rather than economic institutions.

The Industrial Revolution may be defined as the changes caused by the substitution of power machinery for the handicrafts and of the factory system for the domestic system of manufacture. Capital goods took the form of machinery instead of hand tools; power-driven automatic devices replaced the muscle and skill of craftsmen. The scene of manufacture shifted from home to factory.

It is difficult to give exact dates for the Industrial Revolution, as it was a gradual evolution, the suddenness and rapidity of which were relative only as compared with other periods of history. One cannot say exactly when the Industrial Revolution began or just when it ended. Perhaps it is still in progress, for the series of inventions has been continuous. The process of industrialization took place at different times in various industries and in different countries. The Industrial Revolution, which began in the English textile industry in the latter half of the eighteenth century, continued during the nineteenth and twentieth centuries in ever-widening aspects, spreading to other lands and revolutionizing not only methods of manufacture but also transportation, communication, and illumination.

A new phase of the Industrial Revolution developed in the United States between the First and the Second World Wars. It extended the

factory system through mass production and the assembly line; it supplemented the steam engine with electricity, the gasoline motor, and the Diesel engine; it introduced such marvels of industrial chemistry as synthetics and plastics.

1–13. Machinery and Technology. *a. Nature and Relationship.* The machine is a device that is operated more or less automatically. It is a complex of simple tools, propelled by some natural force, such as steam or electricity. Machines may be classified by the kind of power used or by their degree of automaticity.

Technology is a modern form of acquired knowledge or developed skill that has supplanted ancient "rule of thumb," or customary method of doing things. It may be regarded as the application of science to the problems of economic production. It may be illustrated by scientific management and industrial research.

The growth of accumulated wealth and acquired knowledge, which are secondary aids in production to the primary factors of land and labor, has been continuous and interrelated. The development of science has stimulated inventions and discoveries. Modern technology has produced machines of various types; and machines, in turn, have aided technology in further inventions.

b. Effects on Home and Farm. The invention of power machinery resulted in a transition from the domestic system of manufacture to the factory system. Spinning, weaving, and shoemaking are now performed in factories instead of homes. This is true also of other occupations such as baking, preserving, dressmaking, and laundering. Still other inventions, such as the vacuum cleaner, have lightened the few tasks still done at home.

The farmer has been aided by such mechanical devices as the tractor and the harvester. Electric power and the gasoline engine have resulted in increased output with decreased effort. The telephone, the radio, and the automobile now keep the farmer in daily communication with the outside world.

c. Good and Bad Results. It is unnecessary to write at length of the tremendous productivity of power machinery as compared with that of the hand tool. A grinder of grain in Periclean Athens could produce a maximum of only two barrels of flour a day, but a modern Minneapolis flour mill has an ordinary daily output of thousands of barrels. Many similar instances of the superior productivity of the machine might be cited.

Modern technology and power machinery have produced more and cheaper goods. They have permitted higher planes of living with increased leisure time for their enjoyment. Although greater uniformity of product has become necessary because of the mechanization of production, quality

has not been sacrificed to mere quantity. Nevertheless, mass production requires standardization.

The machine has not been an unmixed blessing. A new strain has been placed upon the worker, who has sometimes been sacrificed to his product. The human organism cannot adjust itself perfectly to the regular rhythm of the machine, the continuous operation of which becomes monotonous and fatiguing. Moreover, industrial accidents have increased in number and severity because of the use of newly harnessed forces of nature, whose powers of destruction are as great as those of production. These disadvantages of the machine tend to offset its great advantages.

1–14. Division of Labor. *a. Types.* Specialization is division of labor viewed from an individual point of view; cooperation is division of labor viewed from a social point of view. There is geographical, as well as individual, division of labor, *i.e.*, countries, like people, tend to specialize in certain occupations. There is also division of labor into stages, as well as into occupations, *i.e.*, specialization may be traced over a period of time as well as seen at a given time.

A broad division of labor among various occupations is very old. The antiquity and ubiquity of occupational division of labor are attested by the prevalence of such names as Smith, Miller, Weaver, and Shoemaker. Modern division of labor, however, has divided these general occupations into minute tasks. The old-fashioned shoemaker bought the leather, cut it into its proper parts, and sewed them together by hand into the finished product. But today the manufacture of shoes is done largely by machinery. There are many different machines, and the manufacture of a single pair of shoes requires numerous separate operations. One worker cuts the leather, another operates a sewing machine that stitches the soles to the uppers, and another does nothing except nail on heels.

b. Relationships. The relationship between division of labor and the invention of machinery is a functional one. Although specialization into minute tasks was caused by the invention of machinery, specialization makes for the further invention of machinery. When a complicated process is broken down into many simple tasks, it is not so difficult to devise a machine which will automatically perform a single operation.

c. Effects. Division of labor, like power machinery with which it is associated, results in more goods and cheaper goods in less time; however, it tends to destroy the individuality of both the worker and his work. Extreme specialization resolves the working day into a continuous repetition of simple tasks. These disadvantages of specialization, however, like those of machinery, are partially offset by workers' gains in increased leisure and improved planes of living.

1–15. Roundabout Production. *a. Nature.* The primary factors in production, as previously indicated, were man and nature. The primitive

or simple method of production was to apply labor directly to land for the production of a consumption commodity, such as grain for food and fiber for clothing. Later, however, production was more indirect but more efficient. It has been called roundabout or capitalistic production because the early stages are devoted to the creation of capital goods rather than consumption goods.

b. Results and Requirements. Roundabout, or capitalistic, production is more effective than the primitive, or direct, method; but as the industrial process has lengthened, its hazards have increased. Many capital goods are so highly specialized that they cannot be used for any purpose other than the one for which they were originally designed. The roundabout method of production requires the industrial process to be carried on in anticipation of demand, rather than in response to it. It assumes a steady, continuous demand; sudden changes in economic wants are disturbing. Capital is invested in specialized machinery and in goods in process at various stages on their long journey toward finished consumption goods. Extreme fluctuations in consumers' demands and sudden changes in methods of production are more serious in the capitalistic and roundabout economy of today than in medieval economic society, in which production was carried on by individual craftsmen in response to custom orders.

The roundabout method of production requires capital, and the formation of capital, in turn, necessitates abstinence. Capital is the seed corn of industry; a portion of the product must be saved and reinvested in capital goods. All income cannot be expended as consumers' goods; there must be a replacement fund for industry, and, indeed, an expansion of capital goods.

The roundabout method of production requires not only capitalists who save, but also enterprisers who direct the course of production and who accept pecuniary responsibility for it. A socialistic society would have its capital owned collectively and its course of production determined by a governmental agency. Such, however, is not the case today in the United States. As stated before, the term "capitalism" implies not only the existence of private property rights in capital, but also the direction of production by private business enterprisers. Individual or corporate capitalists own most of the instruments of production and employ laborers to work for them. As these workers cannot wait until the products of their labor ripen into consumption goods, they must receive advances from their employers in the form of wages. The enterpriser who underwrites and undertakes such a project receives what is left over after expenses of production have been paid. He may make a profit or incur a loss, but his return is both risky and residual on his venture capital.

1–16. Large-scale Production. Large-scale production includes large-scale manufacture, large-scale marketing, and large-scale administration.

a. Manufacture. Large-scale manufacture may be defined as an expansion in the size of a plant to the point of maximum efficiency or the optimum of lowest average costs. This varies from plant to plant, from industry to industry, and from time to time.

The transition from early water-power mills to later steam-power factories was generally accompanied by an increase in the size of the plant. The recent development of electricity, however, may stimulate a return to the smaller sized manufacturing unit, at least in the lighter industries.

Large-scale manufacture makes possible not only an increased use of machinery and an extension of division of labor, but also the profitable utilization of by-products that were formerly wasted. Meat packers boast that the only part of a hog that now escapes their economic utilization is its squeal; the pig's bristles are used for brushes, its fats for lard and soap, and its bones for buttons and fertilizer. Large industries maintain well-equipped laboratories, in which elaborate research is done; they can devise new products and additional uses for their goods. The General Electric and Du Pont Companies are outstanding examples.

b. Marketing. Large-scale marketing is the multiplication of merchandising outlets. It may take the form of similar stores in different neighborhoods, as in the case of chain stores, or of different types of stores under the same roof, as illustrated by department stores.

c. Administration. Large-scale management represents the union in a single organization of two or more manufacturing plants or merchandising units. Large-scale management permits many savings in administration and distribution. Important economies in buying, selling, and shipping are thereby achieved.

Large-scale production in any or all these forms may lead to monopoly, but expansion and combination are not inherently and inevitably monopolistic. Monopoly has been defined as sufficient power over the supply of a good to regulate its price. Problems of monopoly will be treated in Part Seven.

1–17. Specialization Causes Interdependence. Division of labor and expansion of commerce developed simultaneously. At any time and place specialization is as deep as exchange is broad. Division of labor must be accompanied by trade, in order that each specialist may enjoy the different products of other specialists. Thus commerce turns the specialization of individuals into the great cooperation of society as a whole.

The feudal manor of the Middle Ages was an economically self-sufficient unit, but the revival of commerce following the Crusades expanded this

local economy and ended such isolation. Nationalism and capitalism were nurtured in this period of geographical expansion, which opened new markets and additional sources of raw materials. Nations began to specialize in the production of those things for which their soil, climate, and labor forces were best adapted and to exchange them for the different products of foreign lands. Finally, the Industrial Revolution made England a great industrial nation that specialized in manufactures and ceased to raise most of its own food.

Just as power machinery implies mechanization, and large-scale production involves standardization, so division of labor means specialization. Division of labor creates interdependence. Commerce is essential for specialists to exchange their different products with each other. The world of today is economically interdependent in a measure hitherto unknown. People starve and pestilence rages when the healing stream of commerce is checked. The First and Second World Wars are horrible examples of distorted production and disturbed trade relations.

1–18. Exchange Requires Valuation. Exchange and distribution necessitate the determination of the relative value of each product of, and every factor in, the wealth-creating process. If a shoemaker wishes to barter his shoes for the clothes of a tailor, on what basis shall this exchange take place? A suit of clothes is worth how many pairs of shoes? To facilitate this process of valuation and exchange, the economic institutions of money and credit have been developed.

Value may be defined as the power of one good to command another good in exchange for itself. Thus, value is merely an exchange ratio, such as three pairs of shoes for one suit of clothing. Utility, or value in use, is the power of a good to gratify a want in the process of consumption.

The primitive method of valuation and exchange, known as "barter," was to trade one economic good directly for another, in whatever ratio was acceptable to both parties to the bargain. Modern pecuniary society, however, is an indirect exchange economy of money and markets.

1–19. Money and Credit. Money may be defined as that commodity possessing general acceptability for purposes of exchange. Price is merely value expressed in terms of money. Although the purchasing power of any medium of exchange, such as the American dollar or the British pound sterling, fluctuates from time to time, it is an accurate measure of value at a particular time.

Credit is an economic device resting on confidence; it permits possession in the present with payment in the future. Credit is a financial mechanism by virtue of which paper claims on wealth, instead of the actual wealth itself, circulate for exchange purposes. Thus, credit economizes the use of money, for a large amount of trade can take place quickly and easily by the use of a relatively small amount of money. Credit

instruments take the place of money as a medium of exchange, but not as a standard of value. Checks and drafts may be accepted in payment, but they are written in dollars or pounds.

The final stage in the evolution of exchange is that of a credit economy. It is accompanied by the development of intricate financial institutions, such as banks and brokerage houses; of various credit instruments, such as paper money, checks and drafts, promissory notes, and trade acceptances; and of highly organized markets, such as the New York Stock Exchange. These will be discussed in more detail in later chapters.

Guide Questions on Text

1. *a.* Distinguish among economics, ethics, and politics.
   b. Differentiate between pure and applied economics.
2. *a.* In what respects is an economic problem difficult of solution?
   b. Indicate difficulties and disillusionment of panaceas.
3. *a.* Show the origin of economic problems.
   b. What does it mean to economize?
4. *a.* Why do economic problems persist despite progress?
   b. Indicate social costs of technological progress.
5. *a.* What do you understand by the terms "capital" and "capitalism"?
   b. When and where did the revival of capitalism take place?
   c. What changes did the coming in of capitalism involve?
6. *a.* Define industrialism and distinguish it from capitalism.
   b. What is meant by the Industrial Revolution? When and where did it take place? Is it still going on?
   c. What changes are involved by it?
7. *a.* How does a machine differ from a tool?
   b. Indicate some gains and some dangers of mechanization.
8. *a.* Explain different types of division of labor.
   b. Indicate advantages and disadvantages of specialization.
9. *a.* Show nature and origin of roundabout production.
   b. Indicate its gains and dangers.
10. *a.* Indicate different types of large-scale production.
    b. Relate it to mechanization and specialization.

Topics for Investigation

1. Claims of economics to be a science.
2. Relationship of economics to other social studies.
3. Development of capitalism.
4. Great inventions in the old Industrial Revolution in England.
5. New industrial revolution in the United States.
6. Benefits and dangers of power machinery to workers.
7. Effects on our culture and civilization of mechanization, specialization, and standardization.
8. Capitalism in relation to culture and democracy.
9. Imperialism in relation to capitalism and industrialism.

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CHAPTER II

OUR BASIC ECONOMIC INSTITUTIONS

2–1. Production by Private Enterprise. Businessmen are those who coordinate and direct the productive energies of economic society. They include all individuals—from great captains of industry to small venders—who assume the financial responsibility for their respective ventures. If enterprisers are successful in anticipating the wants of consumers and efficient in meeting them, they will make profits. If unsuccessful in their undertakings, losses will be incurred and failure may result.

Industrial society is a great drama of economic triumph or a tragedy of financial collapse. Some individuals are achieving success and rising from a lower economic group to a higher level of financial rewards and responsibility. Other individuals are experiencing losses, and perhaps falling back from industrial leadership into the ranks of wage earners and salaried employees, or perhaps even retrograding into unemployed people. America has been regarded as the land of economic opportunity because of the chances which it affords enterprising individuals to show their ability and to secure the gains of their own industry. The tournament of business is the modern Field of the Cloth of Gold.

Early economists believed self-interest to be the motivating force of economic life. Adam Smith contended that under conditions of free competition production would be guided by self-interest as by an "invisible hand." Each individual knew his own interests best, and happy was the nation that interfered least with business. Price was the indicator that production would follow. The consumer would pay relatively higher prices for articles he most desired. The lure of profits would lead enterprisers into the production of those commodities and services for which demands were greatest.

2–2. Consumers' Desires and Demands. Such an analysis failed to distinguish effectively between desire and demand. The latter may be defined as desire plus purchasing power. Production is determined by articulate demands, not by impotent desires. Because of the unequal distribution of income, slight whims of the wealthy are gratified while pressing needs of the poor are ignored. Hence, the lack of harmony between individual self-interest and social well-being, which Adam Smith failed to discern in his economic system of harmony and his political policy of noninterference by government in industry.

Modern economists are inclined to doubt the ability of consumers always to make wise choices of their own accord. The multiplicity of current economic wants and the wide variety of economic goods now on sale make the consumer a veritable Alice in Wonderland, constantly besieged to buy this or that article concerning whose intrinsic merits he knows little. The development of high-pressure salesmanship and clever advertising may increase, or alter, or even create economic demand. Again, conspicuous consumption for ostentatious display becomes a matter of social prestige instead of rational economy.

2-3. Competition. Despite monopoly in some industries, competition is still regarded as the general rule in modern business. There are many intermediate stages between the rare extremes of perfect competition and complete monopoly; they are sometimes referred to as imperfect competition, monopolistic competition, or quasi monopoly.

a. Types. Competition now tends to assume peaceful, instead of violent, forms. Moreover, group competition has supplemented that of individuals. Illustrations are collective bargaining in industry and corporate strategy in marketing.

There are many types of competition, such as political, social, economic, racial, and military; but we are interested primarily in economic competition. This, in turn, can be classified into numerous subdivisions.

There is economic competition among employers and among employees, as well as competition between employers and employees. There are beneficial forms of competition and destructive forms of competition. There is competition among buyers and competition among sellers; the former force tends to raise prices, the latter, to lower prices.

An important distinction must be made between competition among consumers, which leads to ostentation and vulgar display, and competition among producers, which makes for efficiency in industry. The lethargic enterpriser, who does not effectively satisfy the wants of consumers, is not patronized. But "cutthroat" and unfair competition among unscrupulous producers who put profits above service may be as socially undesirable as conspicuous consumption.

b. Evaluation. Older economists spoke of a natural, or normal, price, which they believed was in the long run kept down to costs of production by economic competition among producers. Hence such liberals as Adam Smith pleaded for a minimum of governmental interference in industry. The natural force of economic competition, under a free system of individual enterprise, was regarded as sufficient protection for individual consumers and for the preservation of social welfare.

The biological struggle for existence has served as an analogy for economic competition. This comparison is suggestive but misleading. Victory in economic competition does not prove mental superiority. Great for-

tunes have been attained by unfair methods of competition and by the manufacture of shoddy commodities. The comparison between economic success and natural selection assumes that business competition is a fair test of inherent superiority. But such is not always the case, for business success may be achieved more by unscrupulous cleverness than by unusual productivity. Moreover, this analogy assumes an equality of opportunity that does not exist. Riches and poverty may be the results of divergent social environments rather than of different native capacities or different degrees of industry. There are artificial handicaps in economic competition, such as private property and the right of inheritance, for which there are no equivalents in the natural struggle for existence.

As economic society has grown more complex, new forms of social control have developed. The modern state has found it necessary to pass laws for the regulation and preservation of competition, on which the older economists placed so much reliance. Unfair methods of competition have been frequent and flagrant. "Combinations in restraint of trade" have been so common that recent economists have suggested that monopoly may be the rule and competition the exception.

The force of competition has been challenged not only on the grounds of its prevalence, but also on the basis of its efficacy. The socialists contend that the present competitive system is not efficient, but wasteful. They project the advantages of large-scale production to the extreme of governmental monopoly.

In reply, it has been contended that socialism would not eliminate competition. A conflict of interest will always exist, and rivalry in some other form would continue. Socialism would merely change the character of this struggle from the economic competition of businessmen for patronage and profits to the political competition of politicians or statesmen for votes and power. The economic competition of capitalism in the market place has been regarded as more efficient and more democratic than the political competition of socialism in parliaments or at the polls.[1]

2-4. Profits Motive. The gain spirit is a pecuniary expression of the economic force of self-interest. It is the power that drives the business machine, unless this motor stalls. Saints and artists may be above pecuniary motives, and in a time of national danger patriotism may rise above profits. But for most people and for most periods the gain spirit is the spark plug of business efforts.

The profits motive has an evil, as well as a good, side. It may lead to the creation of desires for goods that are not beneficial. Adulterated foods, quack medicines, and shoddy clothing seem to find ready markets and to

[1] Carver, T. N., "Essays in Social Justice," Harvard University Press, Cambridge, Mass., 1915.

yield high profits to their manufacturers. Finally, self-interest, as expressed through the profits motive, has led business enterprisers to attempt the suppression of competition and the creation of artificial monopoly.

2–5. Price System. Because of the dominance of the price system, modern capitalism has been called a pecuniary society. Critics lament that the dollar mark is so impressed on our civilization that it cannot be exalted by aesthetic, spiritual, or chivalrous ideals. Because of the pecuniary character of modern economic life, the cynic is apt to snarl that men, like commodities, may be said to have their price.

In a competitive society, in which self-interest is the motivating force and in which governmental regulation of industry is limited, the chief economic stimulus to production lies in pecuniary profits, and the main regulator of both production and consumption is market price.

The high price of a good indicates a relatively great demand for it, or a relatively small supply; while the lower price of another good, which costs about the same to produce, indicates a lower demand, or a relatively larger supply. Hence, market value is the indicator that further production will follow; through the mechanism of the price system production will tend automatically to flow out of the channels of low demand into those of high demand.

It must be repeated that demand is not the same as desire, for demand means effective desire, *i.e.*, a want that is accompanied by sufficient purchasing power to express itself in the market price. Moreover, all economic wants are not actual needs. In view of glaring economic inequalities, it does not follow that market price is the best indicator for production to follow. Although the needs and desires of many individuals for houses may be far greater than the wants of a relatively few individuals for yachts, the demand for yachts may be more effective than that for homes. Hence, under the present price system, the production of luxuries for a few before the production of necessities for all takes place because of the promise of greater profits in the former case than in the latter.

In spite of the barometer of market value and the regulating mechanism of price, a misdirection of production can, and often does, take place. Perhaps this is inherent in our capitalistic economy, characterized by production under a system of competition and individual enterprise instead of a planned economy of collective, cooperative endeavor. The wheels of industry are temporarily halted during economic depressions, which follow periods of overexpansion. These problems of the business cycle will be discussed in a later chapter.

2–6. Planned or Planless Economy. The socialist despairs of a free economic organization founded on self-interest and competition, powered

by the sordid profits motive and controlled by the automatic mechanism of price. He would substitute collective operation and ownership of industry for individual enterprise and private-property rights in producers' goods. He hopes that a spirit of social service will transcend the selfishness of a society dominated by self-interest. Instead of an acquisitive society founded on property rights and dominated by the profits motive, in which the present price system works so imperfectly and so unjustly, the socialist dreams of a functional, economic society, in which production is consciously planned to care for the recognized economic needs of all members of society.

On the whole, however, our industrial system, at least before the crash of 1929, seemed to operate to the satisfaction of most people. To be sure, critics found much to condemn in this bustling confusion called American business life. There was no central authority of experts to decide what goods should be produced, in what quantities, and by what individuals. Nevertheless, the complex wants of countless consumers were met by the same individuals as specialized producers, exchanging their commodities and selling their services to each other. The great depression, however, disrupted our normal economic life; and the Second World War had even more devastating effects. As we shall soon see, the New Deal initiated industrial plans and increased economic controls over our former system of free enterprise.

2-7. Private Property. *a. Nature and Development.* Property is a legal right to acquire and to use exclusively, to buy and to sell, to inherit and to bequeath wealth. The term "property" is used to designate recognized claims to wealth, such as deeds, mortgages, and stock certificates.

It is important to distinguish between the concepts "wealth" and "property." Wealth is a material thing; that term should be used in reference to tangible goods, such as a piece of land, a factory, or an automobile. Property, as just observed, means nonmaterial legal rights. The confusion between wealth itself and the title to wealth is responsible for such problems as those of double taxation, to be discussed in a later chapter.

The institution of private property is the result of a long development. Early societies possessed little wealth except the natural resources by which they lived. These were sometimes so abundant as to be classed by economists as free goods. Primitive capital and consumption goods were usually scarce and individually owned, but land was sometimes regarded as belonging to the entire group. Property rights were first recognized in such personal effects as weapons, clothing, and household utensils. They were extended gradually to natural resources. With the development of roundabout production, property rights in capital or in producers' goods became important.

b. Theories of Private Property. Many theories have been advanced to explain private property. The occupation theory states that this right is based on the prior claim of the one who finds wealth without an individual owner and who appropriates it for himself. The lure of property impelled the explorer, the settler, and the prospector to endure privation and hardship. The conquest theory is similar to the occupation theory, except that it is based on force. "To the victor belong the spoils." Conquerors appropriated not only the lands and other possessions of conquered peoples, but also their very persons, forcing them into slavery or serfdom.

Although the occupation and conquest theories of private property may explain that institution, they do not justify it. The labor theory, on the other hand, attempts to justify the institution of private property on the ground that an individual is entitled to hold and to bequeath the fruits of his own industry. The pioneer who cleared the wilderness and who braved the dangers and hardships of frontier life may have required such an inducement to leave the comforts of home.

The social-expediency theory is similar to the labor theory; it justifies, as well as explains, the institution. As wealth increased, private-property rights grew up. There seems to have been some causal relationship between these developments. The conclusion is that the acquisitive motive stimulated individuals to increased efforts in order to accumulate greater wealth. The social-expediency theory of private property contends that the economic progress of the entire group is advanced by offering to individuals, as an incentive to industry and invention, the right to acquire, to hold, and to bequeath the wealth they produce.

The legal basis of private property is the crystallized custom of our ancestors, written into law and defended by government. The social recognition of private-property rights during past ages has good and bad features, but any changes therein savor of confiscation. A related theory of private property explains that institution as a natural right. A purely legalistic defense of private property is both arbitrary and inadequate; the natural rights concept is so indefinite that it cannot easily be defined or defended.

c. Changing Concepts of Private Property. The fact that private-property rights have a social origin must be emphasized. That institution, like any other, must be justified on the ground of social welfare instead of individual interest. Conversely, any form of private property that has become inimical to the best interests of the group should be abolished or modified. There is no such thing as an absolute property right, legal or natural; property rights are relative and related to group welfare.

Our social morality is constantly changing, and with it our ideas concerning the institution of private property. Negro slavery existed in

"free" America for many years. The Fugitive Slave Law protected the property rights of the slave owner; under the Dred Scott decision of the Supreme Court, the slave had no right whatsoever. It required a Civil War to amend the Constitution and to eliminate property rights in human beings.

d. Present Criticisms. The institution of private property is still under fire from many different positions. The single taxer, for example, contends that natural resources are God's gifts to all people and not the result of human labor or thrift. Consequently, the single taxer objects to private property in land; he regards the landlord as one who has acquired wealth he did not produce.

In his war against capitalism, the socialist would go one step further. He objects to private property in capital as well as in land. Capital is the product of past labor used for further production; it is regarded as congealed labor. The socialist contends that society should reward active production, not passive ownership. Consequently, he would have producers' capital owned collectively, just as he would have large industries operated publicly.

The communist opposes the institution of private property in general. The anarchist would destroy the political state, which he regards as the chief bulwark of private property.

More conservative thinkers approach the institution of private property less rashly. They would grant an individual the right to acquire a modest amount of wealth in any of its three forms, *i.e.*, land, capital, or consumers' goods, but they would deny his right to bequeath an enormous fortune. As the right of inheritance is the source of much economic and social inequality, these reformers would make each individual stand on his own feet, rather than permit him to be carried on the shoulders of his father. Partly as a deliberate social policy and partly for the sake of additional revenues, governments have turned toward the progressive taxation of large inheritances and incomes.

e. Human Rights and Property Rights. Critics of our social system have envisioned a conflict between human rights and property rights. A century ago, for example, John Brown was willing to shatter by force the property rights of slaveholders in favor of the human rights of slaves. Another illustration of this conflict between human and property rights could be seen in some European countries, where the peasants revolted against their landlords and broke up their huge estates. Still more recently, this conflict has reappeared in industrial disputes culminating in sit-down strikes and picketing. It has been contended that workers have human rights to jobs, just as capitalists have property rights in plants.

Comfortable standards of living, decent working conditions, adequate leisure, sufficient recreation, and freedom from the specter of industrial

insecurity are now regarded as reasonable and desirable goals for all members of society. The world owes no man a living, but it does owe every man the right to work for a living under such conditions as will not jeopardize his enjoyment of the good life. These economic ideals are sometimes referred to as human rights—a social concept—in contrast to property rights—a legal concept.

2–8. Social Control and Its Agencies. The conflict of interests, which is the source of many economic problems, impels society to organize in order to protect itself and its members against ruthless individualism and undesirable forms of competition. Social control refers to the influence of society over the thoughts and actions of those individuals who compose it. By the exercise of social control the activities of individuals are brought into conformity with the crystallized opinion of the group. The collective will thus restrains individuals from those actions that are regarded as unsocial, and impels them toward those deeds that meet with popular approval. An unsocial act is one that seems to threaten social well-being and group solidarity; the ultimate test is its effect on group survival and social progress.

All human institutions are agencies of social control. The state, the family, the church, and the school are powerful social institutions that influence our industrial life and are also influenced by it. The state is now the chief agency of social control, as expressed through government in law.

Folkways become mores, *i.e.*, customs become morality, as a given rite or traditional routine becomes associated with group welfare. Society progresses from blind tradition to intelligent public opinion, and from mob mind to deliberative public assemblies. Written law gradually succeeds unwritten custom as history unfolds itself. Even today, public opinion must first be formulated before it can crystallize into law.

Each profession, business, or trade union has its own forms of social control. Thus, we speak of the professional ethics of the physician as different from those of the business world. Violence is condemned by one labor organization but condoned by another. The forms and strength of social control differ among various economic groups.

2–9. From Local to National Control of Industry. Stages of economic evolution have been classified as (1) household, (2) local, (3) national, and (4) world economy. The unit of production and the area of trade have gradually expanded. The agency and the degree of social control have likewise grown, but not so fast or so far; there is the persistent problem of culture lag.

During the Middle Ages the national state was almost nonexistent. Roman imperialism had been succeeded by medieval feudalism. The manor was the economic and political unit of the countryside. What

little trade existed was localized about small towns, where the guilds controlled both government and industry.

The revival of capitalism ended the isolation of medieval manors; feudalism and serfdom disappeared. The authority of the guilds declined with the transition from a local economy to a national system. As kings finally wrested control from the barons and burghers of medieval Europe, they began to regulate industry and commerce. In England the strong monarchy of the Tudors expressed itself in drastic economic measures. The Statute of Apprentices, for illustration, made labor compulsory and imposed on local justices of the peace the duty of fixing wages. Great national trading companies were chartered to carry on foreign trade and to develop newly discovered lands. They often exercised political powers as well as economic functions.

The economic philosophy of this period of national economy, known as "mercantilism," reached its greatest development in the seventeenth century. Mercantilism emphasized foreign trade and explained national prosperity in terms of a favorable balance of trade. Happy was that nation the value of whose exports exceeded that of its imports, and which, therefore, received in return a flow of the precious metals. All sorts of nationalistic regulations of commerce and industry were imposed in order to accomplish this desired result. Bounties were placed on certain exports and duties on various imports. The exportation of gold was sometimes forbidden; its importation was encouraged.

The exploration of new lands overseas expanded economic nationalism into imperialism. Colonies were regarded as legitimate fields of exploitation, from which the mother country could receive raw materials of industry and to which she could export finished goods. British navigation laws, which culminated in the American Revolution, were the products of a mercantilistic philosophy.

2–10. Triumph of Liberalism. A reaction finally set in against governmental interference with industry. In 1776 appeared Adam Smith's "Wealth of Nations," a book that had a tremendous influence on both economic theories and practices. The "father of economics," as Smith has been called, expounded therein his central theme of *laissez faire*, or let-alone policy. He argued the case for free trade among nations and strove to show that industry would flourish best when freed from the vexatious interference of government. Adam Smith regarded the functions of the state as limited to three duties, namely, protection of its citizens from foreign invasion; maintenance of justice at home through the courts; and establishment of certain public works and institutions that were uneconomic for individuals to maintain.

This economic philosophy of *laissez faire* or liberalism found expression in the actions of statesmen. In the early years of the nineteenth century

the British parliaments removed many older restrictions on industry and trade. The Statute of Apprentices, previously referred to, which forbade wage increases, and the Corn Laws, which prevented the free importation of grain, were finally repealed. The theory of *laissez faire* was used by English manufacturers to oppose governmental interference with working conditions. Indeed, this theory is sometimes called that of the Manchester school because of its advocacy by those manufacturers desiring unrestricted access to an abundant supply of cheap labor. The children of the poor were exploited domestically in the mines and factories of England under this new philosophy of "liberalism" just as Negro slaves had been mistreated in foreign plantations under the mercantilistic policies of colonial expansion.

2–11. Decline of Laissez Faire. The Industrial Revolution increased economic interdependence, thus necessitating even greater social control. The introduction of power machinery and the factory system brought about new conditions which made untenable the former theory of *laissez faire* in industry. Under the dominance of this philosophy of individualism, little children and mothers toiled in factories and mines under intolerable working conditions. Labor laws and other humanitarian legislation gradually came into existence.

Today, we produce not for neighbors whom we know personally, but for distant, impersonal markets. Absentee capitalism has succeeded absentee landlordism. The corporate form of business organization is a legal entity, which has taken the place of the master worker who actually knew his customers and his workers. The growth of modern cities has intensified the impersonality of modern life at the same time that it has increased congestion of population. Government has extended its controls; it has organized such public services as water supply and sewage disposal.

A growing concentration has taken place in business organization and new problems such as those of the trust and unfair competition have arisen. Monopolies have become so numerous that a complacent reliance on competition is no longer possible. National regulation of big business has been demanded. Paternalism or governmental control of industry has replaced liberalism or reliance on individual enterprise and free competition.

Still more recently, the state has moved even further from governmental regulation to governmental operation. Socialists have urged that all basic industries be owned and operated by the government, instead of being privately owned and operated under governmental regulation. This development is especially evident with public utilities; it has advanced further in Europe than in the United States. The next generation may move still further left from paternalism to socialism, even as the past gen-

eration moved from liberalism to paternalism. This shift, like the earlier one, will probably not be made suddenly on the broad grounds of general social philosophy, but gradually as attempted solutions to specific economic problems.

2-12. Increased Governmental Controls of the New Deal. For better or worse, during the thirties and forties America witnessed a rapid expansion of governmental functions and a marked increase in Federal controls. Some of this development was an earlier and a gradual evolution, which took place even under relatively conservative Republican administrations. Much of it, however, was a comparatively sudden transition, due to the ravages of the great depression and the emergencies of two world wars. The rugged individualism of Herbert Hoover, a survival of the older philosophy of liberalism, was severely tested by new conditions and badly battered by pressing problems calling for prompt solution. It was supplanted with overwhelming popularity at the polls by the New Deal of President Franklin D. Roosevelt, whose governmental innovations and interventions were so rapid, so numerous, and so serious that this period in American history must be regarded as another democratic revolution comparable to those of Jefferson and Jackson. Its economic changes, good or bad, may prove to be as significant as the political changes of the American Revolution and the social changes of the Civil War; hence the New Deal has been called the "Third American Revolution."

The National Industrial Recovery Act, declared unconstitutional, was replaced by the National Labor Relations Act, the Social Security Act, and the Fair Labor Standards Act, a trilogy that constituted the core of the Roosevelt labor legislation program revolutionizing industrial relations in the United States. Our national currency and banking system also was completely reorganized; our foreign trade policy was revised and even reversed. Conditions leading to the adoption of these innovations and the economic problems that they were designed to solve will be analyzed in subsequent chapters of this text.

The outbreak of the Second World War still further increased Federal controls over business. The War Production Board planned and coordinated American industries; it set priorities and limited procurement to essential industries. The Office of Price Administration sought to stabilize prices and resorted to the rationing of goods.

The sudden and victorious termination of the Second World War brought a prompt demand for the removal of many governmental controls over American business and an end to interference with the private lives of our citizens. The faults of governmental operation were decried and the virtues of free enterprise were extolled. There was an insistent demand from many different groups for a return from paternalism and socialism to liberalism and individualism.

2–13. Mixed Economy of Compromise. Unless the Second World War has a different aftermath from that of the First World War, there will probably be a conservative reaction, but a full return to the individualism of the 1920's seems unlikely. A mixed economy of compromise between free enterprise and governmental operation, including both competition and cooperation, seems in prospect. This trend was illustrated by the passage in 1946 of the Employment Act, which established a permanent council of economic advisers to the President of the United States.

An economy of relative plenty and price stability, of increased employment and improved industrial relations, will require advanced governmental planning and careful subsequent supervision. Can capitalism plan and still remain a system of free enterprise with automatic price controls and with the economic law of supply and demand as the natural directive? If not, a socialized economy is the alternative to this mixed economy of conflict, compromise, and concession. Just as our political union could not continue half slave and half free, so our American economy may experience similar difficulty in having some industries free of governmental control, other industries under strict governmental regulation, and still others under governmental ownership or operation or both.

If our economy is to be publicly planned and supervised, or perhaps operated by governmental bureaus, how can such an economic order be kept free of the political influence of large pressure groups, which may be as menacing to social welfare as the invisible empire of big business? Even great statesmen in a democratic society must be guided by the will of the people; this is often so whimsical that a long-term program of advance planning, devised by experts, could be altered, or abandoned, or even reversed by political elections with new popular slogans.

2–14. Conflict and Choice. The founding fathers were wrong in assuming that liberty and *laissez faire* were synonymous and that government was best when it governed least. They were perhaps shortsighted also in failing to see that strong government was sometimes necessary to protect little people from their big oppressors. Liberty or equality of opportunity is different from, and incompatible with, a flat equality. Witness the conflicts between Hamilton and Jefferson. Liberty meant freedom to the strong to get along on their own abilities in this brave new world of opportunity. Equality was interpreted as the same privileges extended by government to all people irrespective of their merits. It may be illustrated by the extension of the suffrage and rotation in office under President Jackson.

It is equally true that liberty and security, two desirable objectives of our own day, are similarly divergent. The wildcat has the freedom of the jungle but not much security; whereas the house cat has the security of the hearth even though its liberty is restricted. The most secure people

are those in jail; but they have little, if any, freedom. We must compromise between these desirable, but seemingly divergent, ideals of liberty and security.

Socialism promotes security, and capitalism promises liberty. Democratic socialism is politically competitive and economically cooperative. It would replace private enterprise by governmental guidance. It would substitute political competition at the polls for economic competition in the market place. It is yet to be demonstrated that political competition is more efficient and more democratic than is economic competition. It remains for socialism to show that it can improve our methods of production and distribution and raise our levels of consumption above those enjoyed under capitalism.

2–15. Economic Functions of Government. Many attempts have been made to classify functions of government. Some writers differentiate between primary functions of the state, such as protection from foreign invasion and domestic disorder, and secondary functions, such as regulation of industry and provision of social security.

Economic functions of the state, in turn, may be subdivided according to those industries which are primarily competitive and those which are natural monopolies. Unfair methods of competition should be suppressed, and the plan of competition elevated in the first group of industries. Those industries in which competition is self-destructive should be recognized as natural monopolies, to be placed either under governmental regulation or under public operation.

Economic activities of government may be divided also into the following three groups: (1) those that are promotional, such as tariffs and social insurance; (2) those that are regulatory, such as the approval or disapproval of the rates and practices of public utilities; and (3) those that are restrictive or prohibitory, such as "trust busting" or the prohibition of the manufacture and sale of liquors.

The social control of industry may be approached from a still different angle. Governmental interference with industry may be classified according to the interests of consumers, workers, investors, and the general public. The protection of consumers has been sought by the passage of pure food and drug acts and through the creation of such agencies as the Federal Trade Commission. Factory laws, social insurance, and minimum-wage laws are illustrations of governmental interference with conditions of labor. For the protection of investors, most states have passed "blue-sky" laws to prevent fraud in the sale of corporate securities, and the Federal government has created the Securities and Exchange Commission. Finally, there are miscellaneous regulations of industry, which governments have initiated for the protection of the general public. The conservation of forests and the restriction of immigration illustrate this

form of governmental regulation. Economic problems in general relating to the functions of government in giving direction to economic processes in our economy will be analyzed in Part Five of this book.

2–16. Economic Powers of Government. The United States is a federal or dual government. The national government possesses only those powers specifically delegated to it in the Constitution, such as the right to coin money and to regulate its value, the right to impose tariffs (which is forbidden to the individual states), and the exclusive power to operate the postal system. Of special interest to the student of economic problems are the powers of the Federal government to regulate interstate commerce and to tax. The interstate commerce power of the Federal government has been the main source of its authority over business; it has been expanded, particularly since the New Deal, from commerce in particular to industry in general, and from a strict construction to a broad interpretation of interstate business. The Supreme Court has ruled that the power to tax is the power to destroy. Exercising its constitutional authority the national government has used its taxing power not only to raise revenue, but also to regulate business.

Individual states have all residual powers not specifically delegated to the Federal government in the Constitution. They also possess what is known as the "police power." This is a vague authority, implied in judicial interpretations, rather than expressed by legal statutes, to restrict the constitutional guarantees to individuals of liberty and property when their exercise would menace the public safety, health, and morals or would jeopardize the social welfare and existence of the group as a whole. Under their police power, the states have expanded their sphere of governmental regulation and social control, much as the Federal government has done under its interstate commerce and taxing powers. In both cases the impetus for this expansion of governmental power has come from the urgent necessity of solving pressing economic problems of general social concern to all citizens.

Guide Questions on Text

1. *a.* Outline various types of competition.
   b. Which do you regard as desirable and why? Which seem undesirable and why?
2. *a.* Show how the price system operates as a regulating force over production and consumption.
   b. What defects are there in this automatic regulation of industry?
3. *a.* Indicate and evaluate advantages and disadvantages of the profit motive.
   b. What better economic incentives can you suggest?
4. *a.* How do you define the institution of private property?
   b. Define and distinguish wealth from property.
5. *a.* What justification would you make of private property?
   b. What limitations would you put on this institution?

6. *a.* What do you understand by social control?
   b. Illustrate agencies and methods of social control.
7. *a.* What is meant by mercantilism?
   b. Indicate its basic philosophy and chief policies.
8. *a.* Briefly explain the assumptions and philosophy of *laissez faire*.
   b. What economic forces led to its adoption and subsequent modification?
9. *a.* Outline economic functions of government.
   b. Which seem proper or desirable and why? Which seem undesirable or doubtful and why?
10. *a.* What is implied by the expression "a mixed economy"?
    b. Is it desirable or undesirable? Why?
    c. Is it practical or impractical? Why?

Topics for Investigation

1. Origin and development of institution of private property.
2. Theories in explanation and justification of private property.
3. Schools in criticism of private property.
4. Changing methods and aims of social control.
5. Regulation of industry and trade by medieval guilds.
6. Mercantilism, yesterday and today.
7. Doctrines and influence of Adam Smith.
8. The New Deal or the "Third American Revolution."

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Part Two

PROBLEMS OF BUSINESS ORGANIZATION

CHAPTER III

FINANCIAL ORGANIZATION AND MANAGEMENT OF BUSINESS CORPORATIONS

3–1. Usual Forms of Business Enterprise. Private enterprise is a fundamental characteristic of our free economic system and a basic institution of modern capitalism. The enterpriser takes the initiative in production; he brings together the various factors in production. The business enterpriser directs the undertaking, assumes responsibility for it, and receives as his share in distribution the residual portion, whether it be profits or losses.

The most familiar forms of business organization are (1) individual enterprise, (2) partnership, and (3) corporation. Most businesses were formerly conducted by individual enterprisers; these men are still in control of most small undertakings. But the growth of large-scale production and the development of roundabout or capitalistic production have made the corporate form of business enterprise of paramount importance in our present economic organization. Hence, this chapter stresses economic problems relating to the financial organization and management of business corporations.

3–2. Unusual Forms of Business Organization. In addition to the above three common types of business organization, there are four other forms: (1) cooperative, (2) trusteeship, (3) receivership, and (4) public or governmental enterprise.

Cooperatives would substitute the mutual gain of the entire group for the private profit of individual enterprisers, and the democratic principle of one vote to each stockholder for the traditional corporate practice of one vote to each share of stock. Cooperatives will receive special treatment in a later chapter.

A trusteeship is a legal device that permits one person or several people jointly to act for another person or for other people. Court approval but not incorporation is necessary. Estates may be left in trust for immature or incompetent heirs. An improper use of the trusteeship for concentrated control of big business will be discussed in the chapters on monopoly.

A receivership results from bankruptcy proceedings growing out of failure to pay past due debts. The court appoints an individual or a

corporate receiver to administer the finances of an insolvent debtor, in order to secure payment of outstanding obligations, or, at least, fair and equal treatment of all creditors. As we shall see in later chapters, the great depression of the thirties forced many railroads and other important business organizations into receivership.

Finally, public or governmental enterprise, in the form of public ownership or operation, or both, of many public projects is now common. Socialists would move all basic and large-scale industries from private ownership under governmental regulation to public ownership and operation. These issues will be treated more fully in later chapters devoted to public utilities and socialism.

3–3. Nature of the Corporation. A corporation is an association of individuals legally bound together by a certificate of incorporation and cooperating for the performance of some group function. A business corporation is such an association of natural or legal persons, authorized by the state or the Federal government in an instrument called a "charter" to transact business of a specified character. A corporation is a legal entity, for it possesses an existence apart from that of the individuals who own shares in it. It is regarded by the state as a legal person.

The ownership in a business corporation is expressed by shares of stock, each stockholder being owner of a participating interest in the corporation proportionate to the number of shares owned. The corporation is authorized by the state to obtain a certain amount of capital with which to conduct its business. This authorized capital may or may not be raised entirely at the time of the formation of the corporation.

Although final control of a business corporation rests with its stockholders, actual management is delegated by them to their representatives, known as directors of the company. A corporation may buy and sell property; it may sue and be sued in court. In many other respects a corporation may act like a natural person for the transaction of its business; however, the legal conception of a separate corporate entity, distinct from that of its shareholders and officers, has been attacked by recent court decisions. The natural persons behind the corporate mask have been sought out; responsibility has been placed upon them for alleged offenses of the intangible corporation, which can be fined but not imprisoned.

The birth certificate of a corporation is its charter, which states the functions that have been vested in the company; the corporation has no powers other than those specified or implied in its charter. If a corporation violates its privileges or exceeds its rights, it may have its charter revoked by the state that created it. Unauthorized acts or unwarranted extensions of its activities are expressed in legal terminology as *ultra vires*, meaning, beyond its powers. As long as a corporation performs only those

functions for which it was created, it may continue in existence for an indefinite period. Although a time limit may be specified in its charter, the corporation may apply for a new charter or for an extension of the old one.

Under the Constitution of the United States, "Full faith and credit shall be given in each state to the public acts, records, and judicial proceedings of every other state."[1] The result is that a corporation doing an interstate business may ordinarily be chartered in any state that it desires. It may then do business in any one, or several, or all other states. In the conduct of its business, however, the corporation is subject to the laws of the state in which it is operating.

3–4. Kinds of Corporation. Corporations are organized for economic, political, social, educational, and religious purposes. A business corporation, like the Ford Motor Company, is an example of an economic corporation. Cities and incorporated boroughs are political corporations, having charters from their state legislatures. Incorporated clubs and fraternities illustrate social corporations; colleges, educational corporations; and churches, religious corporations.

Corporations may be classified also as public and private. Incorporated political units are examples of public corporations; ordinary business corporations illustrate private corporations. In addition, there are quasi-public corporations, such as railroad and other public-utility companies.

A basic distinction is that between business corporations and all other corporations. Business corporations, organized for profit, have capital stock, whereas other corporations, not organized for profit, have no stock.

Public corporations, such as cities, are incorporated for the political purpose of community government; they are operated for public benefit and not private gain; they may issue bonds, but not stock. It is with business corporations, organized for gain and with authorized capital stock, that we are chiefly concerned in this chapter.

3–5. Development of the Corporate Form of Business. At the time of the adoption of the Constitution of the United States, in 1789, there were only 21 business corporations of all kinds in this country. They were primarily toll-bridge and turnpike companies, water-supply companies, companies for improving inland navigation, and insurance and banking companies. These were the most common types of business corporations until the development of the railroads in the nineteenth century.

Industrial corporations were not significant in this country until after the Civil War. Because of the destructiveness of this great conflict, it was necessary to raise huge amounts of capital for reconstruction. Again, there was the challenge of westward expansion and the construction of transcontinental railroads. Finally, as business activities developed on a

[1] Art. IV, Sec. 1.

larger scale than ever before, they demanded a bigger and better form of business organization than that of the individual enterpriser or the partnership. Consequently, the corporate form of business organization became common; it was well suited to the raising of large funds because it could combine the savings of many investors.

Expansion of business activity during the last generation of the nineteenth century resulted in the establishment of no less than 51,094 manufacturing corporations within the United States by 1904. According to the Federal Census of Manufactures, their number further increased to 91,516, or by no less than 80 per cent in the next fifteen years from 1904 to 1919.

For the year 1932, 91,849 manufacturing corporations filed income-tax returns with the Federal Collector of Internal Revenue; for 1933, 87,433 manufacturing corporations did so. From 1919 to 1932–1933, then, in contrast to the earlier period, 1904 to 1919, increase in number of business corporations almost ceased. Corporate growth continued, but it was in size and power. The depression also discouraged new ventures.

3–6. Recent Trends. Expansion in size of existing corporations, rather than a multiplication of new companies, continued at an accelerated rate. The Securities and Exchange Commission reported in 1945 that the total assets of more than 14,000 representative companies engaged in various industries increased by 19 billion dollars from 1939 to 1943; their net worth increased by 5 billion dollars. The total assets of 400 nonmanufacturing companies increased by over 2 billion dollars and their net worth by almost 1 billion dollars in the same brief period.

The popularity of the corporate form of organization has spread from private industry to governmental business. The depression of the thirties brought into being the giant Reconstruction Finance Corporation for the public support of private business; its blood transfusion of Federal loans flowed into the veins of private corporations, bringing them back to life by the quickening pulse of public credit. The Second World War necessitated many other governmental corporations for the emergency tasks of industrial conversion and reconversion.

3–7. Current Significance of Corporations. Although corporations are a minority of all manufacturing establishments in the United States, about nine-tenths of all our manufactured products are made by them. The great majority of all employees engaged in manufacture are those employed by corporations, some of which have many plants.

Over half a million profit-making corporations of all sorts, with assets of over 300 billion dollars, currently report annually to the Bureau of Internal Revenue. Their gross sales were 161 billion dollars in 1929 at the peak of prosperity and 84 billion dollars in 1933 at the depth of the great depression, or almost twice the national income for each of these two years.

The ownership in American business corporations is diffused among thousands, if not millions, of people, who receive each year several billion dollars in dividends. When to this number is added the thousands, or perhaps millions, of people who own bonds and receive several billion dollars a year in interest payments thereon, the pecuniary importance of the corporate form of business organization and the wide diffusion of ownership of corporate securities become evident.

3–8. Advantages of the Corporate Form of Business. A corporation can accumulate large amounts of capital by appealing to numerous investors with funds of varying size. Corporate units of ownership, represented by shares of stock, are valued at different amounts, varying from several dollars to hundreds of dollars per share. Consequently, a corporation can avail itself of a greater number of investors and therefore of larger funds than a single enterpriser or a partnership.

Each partner is ordinarily liable for debts incurred by an associate in the name of the partnership. This liability transcends investment in the partnership and extends to other property, which a creditor can attach for payment of obligation. Limited partnerships, legal in some states, are exceptions to this rule. These usually include a managing partner, whose investment is often slight and whose liability is sometimes unlimited, and one or more silent partners having capital in the business, whose liability is limited by the articles of partnership to a specified amount, frequently that of the investment. The liability of a stockholder in a corporation, however, is generally limited to the amount of his investment. Exceptions to this rule have been national banks, where the stockholder's liability has been double that of the par value of the bank's stock registered in his name.

Exchange of investment is facilitated by the corporate form of business. A partner often finds it difficult to sell his interest in such a business without the consent of his other partners. A stockholder, on the other hand, usually can sell his shares in the corporation to anyone who wishes to buy them. Stock exchanges provide ready markets for the securities of large corporations.

Finally, the corporate form of business organization possesses the great advantage of perpetuity of existence. A partnership is dissolved by the death or withdrawal of one of the partners, but the death of a stockholder does not impair the life of the corporate business. The corporation, having an existence apart from that of its individual stockholders, can survive their death or departure.

Because of these advantages of the corporation, it has become the chief form of business organization in all large ventures. But individual enterprise and the partnership continue to be common and popular for small undertakings. Both are simple and economical forms of business or-

ganization. Incorporation is cumbersome and expensive. Corporations pay certain taxes not levied on other forms of business; they also find the evasion of ordinary taxes more difficult than do small enterprisers, many of whose records are inaccurate or incomplete.

3–9. Promotion of a Business Enterprise. In our capitalistic economy, new avenues of production are opened, and expanded opportunities for increasing the national wealth are developed by private or individual initiative, motivated by the quest for personal gain.

A promoter is an enterpriser who specializes in the organization of new projects. He is the active element who brings the funds of the passive capitalist out of banks and other savings institutions into business undertakings. The promoter initiates production so that industry can venture forth into broader fields of endeavor. The promoter discovers and assembles what he considers a business opportunity; the investment banker evaluates the project before deciding to finance it. The promoter must be creative, the banker should be critical.

The process of promotion may be divided into four stages: (1) discovery, (2) investigation, (3) assembly, and (4) finance.

The discovery of a business opportunity lies in the stimulation of new wants or an improvement in existing methods of production. Discovery should be followed by careful investigation because an unforeseen objection or difficulty can transform profits into losses. The promoter, therefore, gets reports on materials and methods. He makes market surveys and cost estimates.

Assembling an economic venture is as difficult and important as its discovery and investigation. Assembly has been defined as "the process of getting and keeping control in the hands of the promoter." The promoter seeks to fortify himself against the capture of his project by someone else. He does so by the registration of patent rights and the acquisition of valuable sites or sources. He generally purchases options, or rights to buy later, instead of making outright purchases; in this manner, limited funds do more during the short but critical period of promotion than would the immediate acquisition of full title to fewer properties.

The final stage of promotion is that of financing a project. The right to participate in a business opportunity may be sold directly to the investing public or indirectly through brokers and investment bankers. Both methods are common, but the indirect method is generally followed in large enterprises and the direct method in small ones.

A large corporation that is in the process of formation or expansion will not ordinarily attempt to do its own financing. The rights of participation, as represented by stocks and bonds, will probably be sold by some large investment house. If the total value of these securities is great, several investment houses may combine into a syndicate to underwrite

that issue. They guarantee to buy the securities at a certain price and strive to sell them at a higher figure. The profit of the banking syndicate lies in the margin of difference between the purchase and sale prices. If the market will not absorb these securities at their estimated price, the underwriters may be forced to lower it and to take the loss that such a reduction involves. Securities may be listed subsequently on the New York Stock Exchange, the Curb Exchange, or some local exchange. The estimate of the participating investment banker, as a rule, approximates the price at which the securities will be absorbed by the market.

3–10. Process of Incorporation. One of the problems in organizing a business corporation is selection of the state in which to incorporate. State corporation laws differ widely as to costs, ease, and methods of incorporation. In selecting the state in which to incorporate, the general rule is to incorporate in the state in which the chief business is to be done. Sometimes this is neither desirable to do nor easy to determine. Organizers of corporations, therefore, frequently employ the services of consulting attorneys who are specialists in the corporation laws of various states.

After a decision has been made concerning the state in which to incorporate, an application for a charter must be presented to the secretary of state or some other official who is charged with the duty of receiving such applications. The signatures of several incorporators must be attached to the application. It is commonly required that some of the petitioners and officers be citizens of the state in which incorporation is sought.

The application for incorporation must ordinarily contain the name of the proposed corporation, the purpose for which it is being formed, the place of business, the desired duration of the corporation, the names and residences of subscribers to the capital stock, and the number, names, and method of election of its directors. The application must state also the total amount of capital stock for which authorization is desired and the amount of capital stock which has actually been subscribed. A certain portion of the total stock must be paid for at the time application is made, and a substantial amount of cash should be in the hands of the treasurer of the company.

The application for incorporation should be duly drawn up and attested by a notary public. It must be accompanied by a fee for administrative expenses involved. A bonus, or tax for the privilege of incorporation, is often necessary. It is commonly required that applications for incorporation be given advance publicity in newspaper advertisements.

The authority to issue corporate charters varies somewhat in different states. In Pennsylvania, for example, applications for incorporation are made to the secretary of the Commonwealth, but the governor must

approve and issue the letters patent, a document officially confirming the fact that certain associates are incorporated under a corporate name and charter. This document and the charter, which is a more detailed certificate of incorporation, are first registered by the proper state officials and then sent to the officers of the new corporation. After receipt of the corporate charter, an organization meeting of the incorporators and stockholders is held. Permanent officers and directors are then elected, and bylaws are drawn up in conformity with the charter.

3-11. Corporate Democracy. A business corporation is an economic democracy that presents not only opportunities for liberty of action but also dangers of corruption similar to those of our political democracies. Several distinctions, however, are important. A stockholder ordinarily possesses as many votes as he has shares of stock. Moreover, actual attendance at meetings of stockholders is not necessary. Voting may be done by proxy, as well as in person. A stockholder may fill in the blank form which he has received by mail and which authorizes a specified officer or several officers of the company to cast for him the number of votes to which he is entitled.

The ultimate source of authority in a corporation rests with its stockholders. They do not participate in the conduct of the business, however, any more than the voting population of a large city shares in the actual management of municipal affairs. Stockholders elect directors who shape the policies of their business, just as citizens elect their legislative representatives. Administrative officers of a business corporation, like those of a government, are sometimes elected directly by the stockholders, sometimes indirectly by the directors, or legislators. The duties of officers of a company are fixed in the charter and bylaws of that corporation, just as governmental officials derive their authority from the Constitution and from statutes passed in conformity with it.

A corporation is a constitutional democracy, *i.e.*, its bylaws must be made in accordance with the general provisions of its charter, as well as in conformity with the laws of the state in which it is incorporated and those of the states in which it does business. It is desirable, therefore, not to include too much plan of organization in a charter. Conditions may change, and it is easier to alter bylaws than to make application for a new charter or to amend an old one. Changes in corporate bylaws are ordinarily made by vote of the directors with subsequent ratification by the stockholders. Amendment of a corporate charter, however, requires application to the appropriate officials of the state which issued the charter.

3-12. Organization of an Industrial Corporation. There is no single, rigid plan of organization suitable for all business corporations. Indeed, one of the advantages of the corporation is its flexibility. The type of

corporate organization depends chiefly on the nature and size of the business. Chart 1 outlines a general plan of organization for an ordinary business corporation according to the function, responsibility, and authority of its various departments.

There are three broad divisions of a business: the manufacturing or purchasing department, the selling or marketing department, and the administrative or control department. Various vice-presidents are often utilized as heads of these different departments. A large department

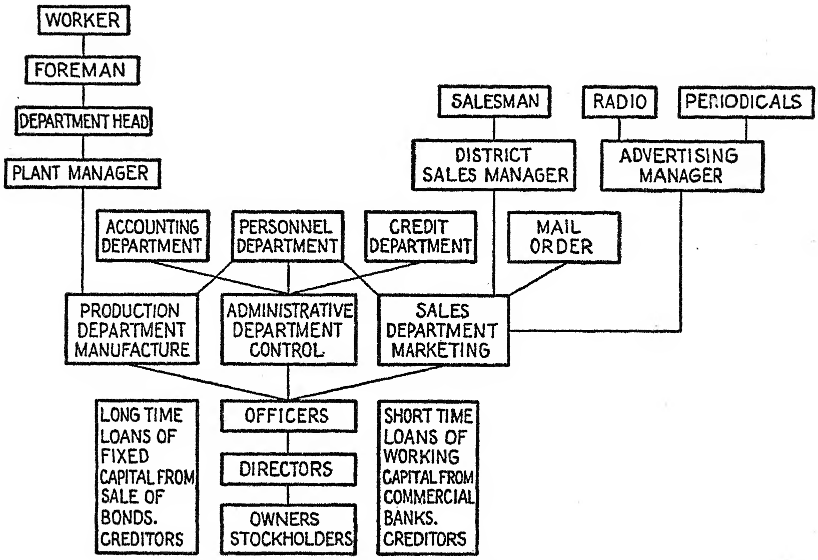

CHART 1. Organization of business corporations.

store is a merchandising rather than a manufacturing plant; here the expert buyer replaces the plant engineer.

The organization of administrative departments varies from industry to industry and from company to company. Control over employees is generally vested in the personnel department, which hires and fires, and which rates and promotes employees. Control over customers is vested in the credit department, which may overrule the sales department in the case of a customer who has bought more goods than he may be able to pay for. The accounting department keeps records from which it compiles periodic financial statements setting forth the condition of the business; its function is financial control. A balance sheet gives the financial picture at a particular date, and a profit and loss statement tells the story over a period of time.

3–13. Sources of Corporate Capital. The capital fund is the result of producing and saving. Corporate capital represents the accumulated

savings and investments of many people. The corporate form of business organization facilitates the determination of the amount and type of investment.

Investment of funds in productive enterprises can be done directly by the investor himself, or it can be done indirectly by the financial institution in which he deposits his personal savings. The large investor puts aside a certain portion of his income for the purchase of stocks through his broker or of bonds through his investment banker. The small investor, however, may not be able to purchase a single bond or share of stock. He consequently resorts to the savings bank, in which he deposits from time to time the results of his thrift. Savings banks are financial middlemen in this process of investment. They collect the small savings of their depositors and invest them in certain types of securities approved by law. Out of the returns, savings banks are able to pay interest to their depositors and to maintain a margin of profit for their stockholders. Such saving is indirect, but not automatic.

Insurance companies likewise invest a large portion of their funds, which they collect as premiums, *i.e.*, periodic payments by policyholders. Although it is sometimes contended that investment by insurance companies represents automatic saving, the payment of premiums by insured individuals, which is the source of company reserves, necessitates thrift and abstinence. Although the *investment* of these savings may be indirect and corporate, rather than direct and personal, the *savings* are not automatic, for individual policyholders must elect to save and to pay their premiums instead of spending this income on consumers' goods.

Finally, there is reinvestment of the funds of a corporation in its own business by the directors, as well as investment through the purchase of its securities by individual stockholders, or by savings banks and insurance companies. Officers of a corporation commonly reserve or reinvest some of the earnings of the company, instead of paying all of them out to stockholders in the form of cash dividends. If profits are so reinvested in the business, the term "surplus" or undivided profits is usually employed to designate them on the corporation balance sheet as liabilities of the corporation to its own stockholders.

3–14. Owned and Borrowed Funds: Stocks and Bonds. Funds of a corporation can be classified as owned or borrowed. Stocks are paper certificates representing proprietary interests of their owners, but bonds constitute creditors' claims in the form of long-term promissory notes.

A stock certificate has on its face the name of its owner, whose endorsement on its back is necessary for its sale. Company books also record the names of stockholders. Coupon or bearer bonds have numbers, but no names on them. No endorsement of them is possible or necessary.

Only their delivery in good condition with all future coupons attached is required when they have been sold.

Par value of a share of stock is its assumed monetary value, engraved on the face of the stock certificate. Par value is commonly supposed to represent the amount originally invested in a business, but frequently it does not. Book value of a share of stock is the company's estimate of the net worth of the capital investment per share at any given time. Market value records the last selling price per share. Both book value and market value may fluctuate widely and differ considerably from each other and from par value. Par value remains constant until it is deliberately changed by the company. Some generations ago almost every stock had its par value, but since the First World War many corporations have issued no par value stock. If a stock has par value, dividends are sometimes expressed in percentages of it; if a stock has no par value, dividends are expressed in dollars and cents per share.

Funds that are borrowed for a relatively long period of time are ordinarily represented by bonds, which are promissory notes usually secured by some fixed capital of the company, such as its buildings and equipment. A banking house commonly acts as trustee, and holds in its vaults the mortgage or written claim on property pledged as security for the loan.

The stockholder has votes because of his ownership rights in the corporation, but the bondholder is an outside creditor without vote. The stockholder receives dividends, often quarterly, but only at the discretion of the directors, when the earnings of the business justify them. The bondholder collects interest at a fixed rate at specified times, generally semiannually, during the lifetime of the loan, stated in the maturity date on the bond. Failure of a corporation to pay its interest charges means that it is insolvent, and a bondholder or bondholders' protective committee may petition the courts to appoint a receiver. The passing of a dividend, however, is within the power of the directors; and, in the absence of fraud, the only redress of stockholders is an election of new officers in the hope of improving the corporation's business and changing its dividend policy.

3–15. Classification of Stocks and Bonds. Stocks may be classified as common or preferred. Preferred stocks pay a specific rate of dividends at definite times. They are generally cumulative, *i.e.*, passed dividends must be paid before dividends can be declared on common stock. Preferred stocks are sometimes convertible into common stock at a specified rate or ratio. They generally have a definite par value and a specified call price. Payments to preferred stockholders take precedence over those to common stockholders, but the obligations to bondholders come before both kinds of dividends. Thus, preferred stock is a compromise between

bonds and common stock. The holders of preferred stock are part owners in the corporation and not creditors. The margin of safety is greater in preferred stocks than in common stocks of a given corporation, but there is less opportunity to share in potential profits.

Bonds can be classified according to their form as either coupon or registered bonds. A coupon bond has interest coupons attached to the covenant; these coupons can be clipped from time to time by the bondholder and cashed at any bank on or after an interest-due date. The holder of a registered bond receives his interest payment, as does a stockholder his dividend payment, in the form of a check or draft mailed by the corporation or its agent. Coupon bonds are conveniently transferred, but they are difficult to replace if lost or stolen.

Bonds can be classified also according to the type of security that is pledged. First-mortgage bonds are secured by a prior lien on the company's plant or other real estate; equipment-trust bonds are those in which the equipment used by the company is pledged; collateral-trust bonds are those for which other securities are pledged; debentures are mere certificates of indebtedness, in which there is no specific pledge of assets; income bonds require prompt payment of interest only if earned.

Bonds can be classified also according to the kind of borrowing organization, *e.g.*, governments, utilities, and industrials. There are short- and long-term issues. Finally, bonds can be classified according to the purpose of the particular issue, *e.g.*, road bonds or refunding issues.

3–16. Fixed and Working Capital. The distinction between fixed and working capital is as important as that between owned and borrowed funds. Fixed capital is represented by the permanent assets of a business. Buildings, improvements, and machinery are illustrations of fixed capital. Working capital within the plant consists of goods in process and finished commodities ready for sale. Working capital includes also funds in bank, funds in accounts receivable, and notes receivable.

Although adequate working capital is just as essential to business success as is sufficient fixed capital, its importance is sometimes overlooked, and a business may fail for this reason. A corporation may make the mistake of investing too large a portion of its funds in fixed capital and reserving too small a portion for working capital. The result is an unfortunate expansion that may become serious in periods of business depression. If a large portion of this fixed capital is also borrowed capital, a grave financial crisis may occur. In such an event, huge overhead costs in the form of fixed interest charges may bear down so heavily on impaired income that too small a portion of current funds is left to meet such pressing operating expenses as the purchase of raw materials and the payment of wages. Temporary needs can be met by borrowing from banks if the corporation is in a sound condition and if the general business

outlook is favorable. Bankers, however, are skeptical of a concern in which fixed capital is far in excess of working capital.

Short-term loans are obtained from banks against ordinary promissory notes or commercial paper. The purpose of such bank loans is to satisfy a temporary need for increased working capital, *e.g.*, with which to buy raw materials that can quickly be converted into salable finished goods. Funds thus obtained are not ordinarily employed for an expansion of the plant by an increase in the fixed capital of the business.

3–17. Cycle of Business Operations. A new corporation usually begins with its current assets in the form of cash. The replenishing of this cash

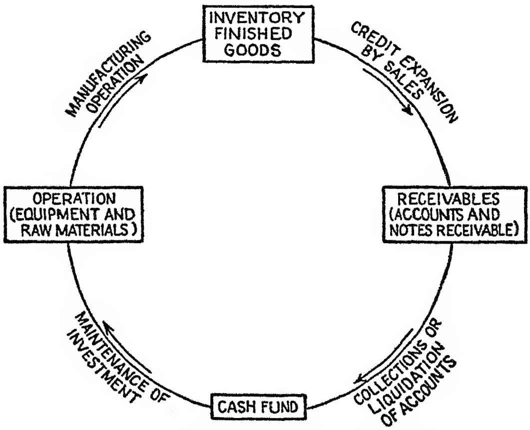

CHART 2. Movement of revolving fund.

fund with continued operation is illustrated by Chart 2. The cash is invested in equipment. Operating the plant results in production. The products are sold, partly for cash, but more generally for credit, or promises to pay in the future. When these accounts and notes fall due, they should be paid in cash, and the revolving fund thus replenished.

The cyclical movement of a revolving fund emphasizes the importance of working capital and the necessity of continuous operation in industry. If cash ceases to flow out, operations cannot continue; without operations no new inventory will result; without sales new inventory will accumulate; and poor collections on sales will diminish the cash fund. Each stage in the process is both a cause and an effect, and a breakdown anywhere along the line will result in curtailment of production.

3–18. Solvency and Liquidity. Solvency and liquidity are so closely related that they are often confused. Solvency is the ability to pay debts when due. Liquidity is the ability to convert inventory into cash in the ordinary course of business. A liquid asset then is one that can be turned into funds with ease and promptness and with little or no loss in value.

In contrast, a frozen asset can be converted into cash only at serious loss or only after a long wait for capital values to rise or thaw out. When the cash fund flowing in from sales and collections is temporarily insufficient to meet a sudden expansion in operations or a large purchase of raw materials, recourse is had to outside agencies for increased working capital. The function of commercial banks and credit houses is primarily to provide additional working capital for industrial enterprises. These institutions will lend their accumulated funds to their customers in exchange for various types of securities and guarantees to repay the loans within a stipulated period of time, as a rule not over a year. In this manner, industries can replenish their revolving fund of cash and thus continue production.

3–19. Current Ratios and the Business Cycle. Working capital or circulating capital is sometimes defined by bankers in a manner slightly different from the way in which those terms have just been used. In its financial implication, working capital may be regarded as the difference between the current assets and the current liabilities of a corporation. Current assets include working capital that is so liquid that it can be converted into cash in a relatively short period of time, ordinarily in less than a year. Current liabilities consist of those obligations of a corporation that likewise fall due within a similarly short period of time.

It has become a maxim among credit men of commercial banks to regard that business enterprise a fairly good credit risk whose working capital, *i.e.*, the difference between current assets and current liabilities, is equal to its current liabilities. To put the same ratio differently, current assets should be twice current liabilities. If, for example, a business enterprise has $2 of current assets for every $1 of current liabilities, its request for commercial credit will usually be looked upon favorably. This ratio of current assets to current liabilities is commonly referred to as the current ratio.

Too much significance, however, should not be attached to this current ratio without at the same time analyzing carefully the nature of the assets and liabilities, in relationship to the phases of the business cycle and to the character of the industry. During a period of depression, for example, a large inventory of finished goods, evaluated on a cost basis, may temporarily be overvalued. A large amount of outstanding accounts and notes receivable may prove worthless assets in a period of extensive business failures. It thus becomes a matter of considerable importance, to those who judge the credit rating of business enterprises, that they should be familiar with general business and market conditions and that they should appreciate cyclical movements in industry.

The current ratio serves only as a convenient starting point in determining the credit rating of a business enterprise. In periods of rising prices

large inventories, rapid turnover of products, and a relatively small amount of receivables are desirable features. As the volume of business expands during a period of advancing prices, production can be stepped up to keep pace with increased demand for goods. On the other hand, when demand falls off, production is curtailed, and less working capital is needed.

3–20. Economic Significance of the Flow of Working Capital. The unfortunate consequences of curtailment of production by insufficient or decreasing working capital should not be overlooked. It is the continuous flow of working capital through the channels of production that becomes income—purchasing power—to its recipients for their productive contributions. When individual concerns decrease their demand for working capital in proportion as the market for their products declines, their action may be viewed as a sound individual business practice. But when work is interrupted all along the line, by curtailing the circuit flow of working capital, consumer demand decreases with resultant curtailment of production and consequent loss of income.

Every concern should therefore strive to continue the uninterrupted flow of funds from cash into inventory through sales again into cash. The cash paid by business to acquire inventory, in turn, represents the buying power over the inventory, acquired by those who have aided in its production.

Moreover, the conversion of inventory into cash, *i.e.*, liquidating inventory without replacing it, may be a good business practice for enterprisers in a period of declining prices; but it is this very practice that, when resorted to by business in general, makes for declining prices and business depression. The need for business concerns to maintain courageously and continuously the flow of working capital is as important as their prudent provision in advance for adequate working capital.

3–21. Adequate Working Capital. The necessary amount or proper proportion of working capital required by different industries varies considerably. A business conducted on a cash basis, like that of a street-railway company, requires relatively little working capital, although it necessitates a considerable amount of fixed capital. Again, its revolving funds may be fairly large. The steady flow of receipts into the cash fund normally replenishes it, so that extensive bank loans for working capital are rarely necessary. Manufacturing companies, which must extend credit to their customers, require a greater proportion of working capital than do public utilities. Merchandising concerns, such as department stores, require a still higher ratio of working to fixed capital; they need more goods but less plant; they seek a rapid turnover of wares and a high volume of sales.

When a business has an adequate supply of working capital, realized primarily from the sale of its products, it can meet its cash obligations

promptly. From a social point of view, adequate working capital helps to promote a continuous flow of goods for consumption and to provide steady employment to labor. It militates against stagnation in industry and stimulates progress toward general economic well-being.

3-22. Dangers of the Corporate Form of Business Organization. The advantages of the corporate form of business organization, growing out of its legal status, as well as its financial operation and management, briefly described in the preceding pages, are partly offset by certain possibilities for abuse. Flexibility of organization presents opportunities for financial manipulation. The increased amount of capital involved magnifies the incentive to, and the effects of, corporate mismanagement. Some of the chief problems of corporate finance may be outlined as follows:

a. Overcapitalization. Overcapitalization, or "stock watering," has been a serious problem of corporate business. At present, its chief significance is in connection with rates of public utilities. Exorbitant prices and excessive rates yield only modest returns on a fictitious capital investment, inflated by stock watering.

Overcapitalization exists where the total par value of the securities of a corporation is greater than the original cost or present market value of the physical assets which they represent. Overcapitalization has been achieved by giving capital value to such intangibles as public franchises and private monopoly power. The policy of an overcapitalized corporation in anticipating profits has been the reverse of that of a company that has frugally created a surplus out of its past profits. Because par value is not indicative of market value or capital-investment value, the practice of issuing stock without par value, as previously pointed out, has become common among industrial corporations.

b. Concentration of Control with Diffusion of Ownership. Ultimate control of corporations rests with their stockholders, who possess the right to vote for directors and in this way to express their approval or disapproval of the corporate management. In most large corporations, however, the secretary or some influential director may cast the votes of thousands of small stockholders who are absent from the meeting but have voted by proxies. Active members and those who control the votes of a large number of shares dominate the situation. Even though voting may be done by proxy, many small stockholders fail to vote. Concentration of control is further facilitated by the existence of a large amount of borrowed capital. Bondholders ordinarily do not possess even the potential power of voting for directors and thus of influencing corporate policies.

In the years of prosperity before 1929, there was a tendency toward a greater diffusion of stock ownership. Large industrial corporations sold shares of stock to their employees on easy terms, or engaged in profit sharing with them through stock distribution. Many public utilities

likewise sought to convert their customers into stockholders and in this sense to "mutualize." Thus two different influences seem to have been at work, the one making for a greater diffusion of stock ownership, but the other for a growing concentration of control. Employees' stock, for example, was sometimes characterized by voting restrictions. Customers were often sold nonvoting preferred stock of companies whose voting common stock was closely held.

c. Absentee Capitalism. The average stockholder or bondowner knows little about the company whose securities he owns beyond the fact that dividends are usually paid, or interest falls due, at certain times. So long as his income flows in regularly and fully, the small investor is rarely interested in details of the concern's business. The separation of ownership from management, or rather the diffusion of ownership with concentration of control, has created the modern problem of "absentee capitalism," which has succeeded the earlier problem of "absentee landlordism."

The majority of stockholders in a company are ignorant of its many manufacturing and marketing difficulties. They are not informed about labor policies toward the employees of the corporation whose securities they own. Investors rarely take the trouble to read the business reports mailed them. Indeed, many financial statements are too complicated to be easily understood by the general public. It is only after a sudden failure to meet interest payments or to declare the usual dividend that the small investor informs himself about the financial management of the corporation, the success of which is essential to the maintenance of his own income.

d. Financial Manipulation. The corporate form of business organization increases the incentive to fraud and the possibility of deception. Glib salesmen have found it easy to sell many securities of dubious value. To manipulate, or even to wreck, solvent enterprises also has been attempted. Stocks or bonds of corporations in real or fancied difficulty have been bought cheap, and the company sometimes has been reorganized with subsequent gain to the manipulators. The reverse also has been equally possible and profitable. Misleading information has artificially raised the price of a manipulated security. At the opportune time "the inside ring" would unload its stock and get out of the deal. The "innocent investor" was often caught holding the paper bag containing only financial crumbs or worthless claims.

e. Privileges of Directors. Even where there was neither fraud nor financial mismanagement, large stockholders sometimes have appointed themselves or their friends to lucrative positions within the company they controlled. Unscrupulous directors have created sinecure posts with large remuneration and little responsibility. Salaries have often been excessive in terms of duties required or qualifications demonstrated.

Salaries paid its officers have not always been in proportion to the size or success of the business corporation.

During the New Deal there was considerable criticism of the high salaries of corporate officers. Some proposed a limitation of $25,000 on any salary. The increase in surtax rates on personal incomes necessitated by the Second World War almost achieved this very result. A subsequent tendency was the award by corporations of generous pensions to retiring officers of the company. Many such pensions were deserved; some were not; a few were excessive. This development was an upward swing of the social security movement from workers to management. Annuity premiums became costs of production, which were temporarily taken out of excess profits taxes; they must eventually be expressed in the higher prices of those products, unless offset by lowered unit costs of production.

3–23. Holding and Subsidiary Companies. A holding company is one that substitutes supervision and security ownership for actual operation and plant ownership; *i.e.*, a holding company controls the stock of other companies, known as subsidiary or operating companies. The device of the holding company has improved industrial organization, but it has increased financial concentration. It has intensified the problem of diffused ownership with concentrated management.

Illustrations of giant holding companies are: the American Telephone and Telegraph Company, which owns controlling stock of its wire operating and equipment manufacturing companies; General Motors Corporation, which owns controlling stock of companies making its several types of cars or their motors, bodies, or parts; and the United States Steel Corporation, which brought together many formerly independent steel companies by the purchase of a controlling interest in the stock of each. Through the device of the holding company, vast public-utility empires were built up before the stock-market crash of 1929. By a process known as pyramiding, one holding company would own the stock of another holding company, and so on. This practice, as we shall see later, was subsequently restricted by Federal legislation.

3–24. Interlocking Directorates. The following example will show how unscrupulous directors can create and manipulate corporations to their own benefit by the device of interlocking directorates. The companies are fictitious, but they illustrate the common and serious problem of diffused ownership and responsibility combined with concentrated power and profit.

Let us assume corporation A to be a successful manufacturer of automobiles. Let us further assume that several influential directors of corporation A become dissatisfied with their modest profits. They therefore organize another corporation, known as corporation B, technically

independent of A, but practically dependent on A, for the manufacture, or perhaps the mere sale, of automobile bodies or tops suitable for making the automobiles manufactured by corporation A. Because the promoters of corporation B are influential in corporation A, the products of B are assured of a sale to A. The prices that are paid by A may be somewhat higher than those prevailing in the open market or more than the cost of manufacturing the parts by corporation A itself. Thus, the profits of corporation B are made at the expense of corporation A. The scheme is profitable to its promoters because the stock of corporation B is more closely held than is that of corporation A. By the organization of such an "independent" company, the promoters, or rather the manipulators, may "skim the milk and appropriate the cream" for themselves.

3–25. Dominance of Giant Corporations. Most corporations are small in size and limited in influence. Many corporations are, in fact, if not in law, one-man enterprises. On the other hand, a few corporations are huge in size and powerful in influence.

Of the 504,000 corporations filing income tax returns in 1933, the first year of the New Deal, only 594 had assets of 50 million dollars or more. Nevertheless, according to the Twentieth Century Fund, these 594 largest corporations, although only 0.15 per cent of the total number, owned 53.2 per cent of all corporate assets and produced 18.4 per cent of the national income. Indeed, the 273 largest nonbanking corporations, constituting only 0.09 per cent of the total number, together with 102 of their subsidiaries, owned 56.2 per cent of the total assets of this group. In 1943 there were 40 corporations each having assets over 1 billion dollars. Their combined assets then totaled 88 billion dollars. These huge corporations included commercial banks, life-insurance companies, public utilities, and industrial giants.

3–26. Social Significance of Sound Corporation Finance. Problems of corporate finance do not concern merely the corporations themselves and their stockholders. They affect the welfare of many members of the community. Funds invested in corporate enterprises come from the savings of many individuals, some of whom have made considerable sacrifices. The proper utilization of these funds for productive purposes affects the material well-being of all those who have invested in corporate securities. If their savings are squandered in dubious ventures or appropriated by fraudulent promoters, not only is faith in legitimate enterprise shaken, but also actual privation may result.

Most commodities manufactured today are the products of corporations. Misdirection of production or waste on the part of officers of large corporations is serious. The resulting loss may injure not only the investors affected but also the whole consuming public. In our highly specialized economy, much capital is temporarily worthless if allowed

to stand idle. In the final analysis, industrial plants have value not so much as physical objects in the form of buildings and machinery, but as going business concerns. Unless a sound financial policy is adopted by those in control, capital assets may not earn anything. The relative ease with which corporations can accumulate large funds may result in the uneconomic use of much capital.

That there has been considerable waste in modern industry due to financial mismanagement was shown in the report prepared some years ago by the Hoover Commission on Waste in Industry. Such wastefulness did not result merely in higher production costs, and therefore in higher prices; it also brought about a destructive exploitation of our limited natural resources. Financial mismanagement also was a contributing cause of the stock-market crash of 1929. Only caution and foresight by those providing funds can reduce these economic losses; only a keen sense of responsibility and adequate training on the part of those in control can minimize the dangers inherent in the present system of absentee capitalism and permit society as a whole to realize the many advantages to be derived from the corporate form of business enterprise.

3–27. Losses through Purchases of Unsound Securities. Promoters are constantly seeking to sell their various projects to individuals and financial institutions with funds to invest. Many of these "business opportunities" are sound and conservative. Others are highly speculative and sometimes spurious. "Sucker lists" of gullible or wealthy individuals are part of the equipment of the illegitimate promoter or high-pressure salesman who seeks to sell his great expectation by personal solicitation or through alluring letters.

Par value or the dollar mark on a stock certificate represents so much actual money to those ignorant of financial matters; it is assumed by them to be the true value of a share of stock. This magic document, like the chart of hidden gold pieces on Treasure Island, is presumed to afford control over countless wealth. Such "investors" dream of a comfortable future when the dollars will come rolling in from their courageous speculation. Alas, they are often disappointed. A notable illustration was the stock-market crash of 1929; security values suddenly collapsed, as selling the future was abruptly halted.

In spite of all efforts to educate persons of moderate means to a realization of the risks involved in buying the "securities" of new and dubious ventures, it has been estimated that the stupendous sum of one billion dollars is lost by the people of the United States in an ordinary year by the purchase of worthless "securities." This sum is so great that our imagination can scarcely grasp it. It would buy a million motorcars, costing a thousand dollars each; it would build a city of a hundred thousand homes, each costing ten thousand dollars.

Such vast amounts have been lost yearly by the people of the United States in unsound securities, even during periods of prosperity. During the depression years from 1929 to 1933, the annual losses were several billions of dollars, not one billion. The total loss for the entire period, could it be computed, would be a staggering sum of many billions.

3–28. "Blue-sky" Laws. Some states endeavored by various pieces of legislation to protect investors against "wildcat" schemes. These early acts were commonly referred to as "blue-sky" laws, because the promotion of spurious enterprises was formerly so blatant that the cynic imagined that an unscrupulous promoter might capitalize the blue sky above him and sell shares of stock in it to gullible investors.

The first "blue-sky" law was passed by Kansas in 1911; it was followed by similar acts in other states of the Union. Such legislation usually provides that a company seeking to dispose of its securities within the state must first file with some governmental official a statement concerning the purpose of that issue. This financial statement must contain the names of the officers and directors of the corporation and specific information on the business status of the enterprise. State examination and approval must precede an attempt to sell securities within the state borders. Brokerage and investment houses must be registered and their agents must obtain licenses to sell securities. Such state regulation of investment banking is supplementary to the state inspection of commercial banks, insurance companies, and other financial institutions.

"Blue-sky" laws, like examinations by the New York Stock Exchange, do not guarantee those investments that pass such inspection. They merely lessen the possibility of fraud and deception. In addition to state legislation and inspection, the postal authorities of the Federal government are constantly seeking to discover and to punish fraudulent uses of the mails.

3–29. Federal Securities Act. Because of the huge losses suffered by American investors during the early thirties, the Federal government decided that it was its duty to supervise the issuance of new securities. Such legislation was based on the power of Congress to regulate interstate commerce, the concept of which was expanded to include selling securities as well as commodities. As integral parts of the New Deal, Congress passed the Federal Securities Act of 1933, the most important provisions of which are outlined below, and the Federal Securities Exchange Act of 1934, which will be treated in the following chapter.

The Federal Securities Act of 1933 was aimed directly at the "ballyhoo" advertising of new security issues which had characterized the gilded decade before 1929. This law required accuracy of statement and publication of important facts in a financial prospectus. It forbade misrepresentation and the omission of vital information.

It became necessary to file with the Federal Trade Commission (later the Securities and Exchange Commission) a complete financial statement covering most new security issues. The following information was requisite: a detailed account of the capital structure of the corporation, including a certified balance sheet and recent earnings statement; the names of all large shareholders, as well as the list of corporation officers, their compensation, and the commissions to be paid and other expenses involved in "floating" the new issue; and, finally, the purpose of the security issue, the date, and the price at which it would be sold to the general public.

No sale of securities could be made until twenty days after filing these statements with, and their approval by, the Federal government. Heavy penalties, including imprisonment as well as fines, were provided for misrepresenting securities and for selling misrepresented or unregistered securities. All those who signed the registration statement could be held personally liable for damages by the buyer, if he could subsequently show financial losses because of a false statement therein or pertinent omissions therefrom.

This legislation was so drastic that few new security issues appeared for several years after its passage. Apparently the United States had swung from the one extreme of complete absence of Federal regulation of new security issues to the other extreme of so rigid Federal regulation that it was difficult to secure new financing or refinancing, no matter how legitimate the enterprise or how clean its methods of finance might be. The deflation of the great depression, however, was probably a more realistic explanation of the reduction of new issues and of the inability to refinance old issues than was the stringency of the new regulations. The middle forties were again years of inflation and stock-market speculation, in which new security issues appeared and many old issues were refinanced. In any event, the old adage "Let the buyer beware" was replaced by the new slogan "Let the seller beware," so far as new security issues were concerned.

3–30. Proposal of Federal Incorporation and License. The following chapter will explain how Federal supervision was extended from new issues to all securities traded on stock exchanges and how the Securities and Exchange Commission was created to supervise corporate finance and to supplement other administrative bodies, such as the Board of Governors of the Federal Reserve System, which supervises commercial banking, and the Federal Trade Commission, which seeks to eliminate unfair competition in interstate commerce.

A further proposal is that Federal incorporation be required of all new companies and that a Federal license be required of all existing companies engaged in interstate commerce. Such action would seem to be proper

under the constitutional authority given Congress over interstate commerce. It would also seem a desirable step in the direction of greater uniformity of corporate practice and greater control over corporate finance.

As previously explained, a corporation chartered in one state now can do business in any other state, subject to the laws of the state in which it is operating. State laws of incorporation, of corporate practice, and of corporate taxation vary greatly. Federal control would make for greater uniformity and would raise business standards in many states. At least, there would be more complete and more correct reporting. A more uniform system of corporate accounting could be secured. A central office of records would be maintained.

Federal incorporation and license would be required only of big businesses engaged in interstate commerce, which would also be subject to control by the states in which they operate. Small businesses engaged solely in intrastate commerce would continue to be subject to a single control; they would be incorporated in and regulated by the state in which they operate.

Guide Questions on Text

1. *a.* What is a corporation? What are its essential features?
   b. Outline types of corporations.
2. Indicate and distinguish among other types of business organization.
3. *a.* Enumerate advantages of the corporate form of business.
   b. Are there any financial disadvantages?
4. *a.* Outline steps in the promotion of a business enterprise.
   b. Define promotion and assembly.
5. *a.* Distinguish between privileges and position of stockholders and bondholders.
   b. Why is this distinction important?
6. *a.* Differentiate between fixed and working capital.
   b. Indicate sources and uses of each.
7. *a.* What is overcapitalization, or stock watering?
   b. How does it occur? How can it be avoided?
8. *a.* Indicate other dangers of the corporate form of business.
   b. How can they be minimized?
9. Contrast voting by stockholders with voting by citizens.
10. Distinguish among par value, book value, and market value.
11. Distinguish between solvency and liquidity.
12. Explain briefly current ratios for credit analysis.
13. Trace the cycle of business operation.
14. Diagram a plan of corporate organization.
15. *a.* Show the economic importance of corporations.
    b. Indicate the social significance of sound corporate finance.
16. *a.* Give reasons for and constitutional basis of Federal Securities Act of 1933.
    b. Enumerate its chief purpose and provisions.
    c. Has its operation been successful and effective? Why or why not?

Topics for Investigation

1. Growth of the corporate form of business organization in the United States since the Civil War.
2. Combination of huge corporations into super corporations by consolidation or merger.
3. The holding company as a corporate device.
4. Absentee capitalism as the successor to absentee landlordism.
5. "Blue-sky" laws for the elimination of fraudulent enterprises and the sale of worthless securities.
6. How a business is incorporated in your own state. Proposed improvements in process.
7. Practice of issuing no-par-value stock. Evaluate.
8. Growth of corporate surpluses and the desirability or undesirability of a Federal tax upon them.
9. Stock dividends and stock splits. Differences and desirability.

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CHAPTER IV

MIDDLEMEN AND ORGANIZED MARKETS

4–1. Conditions of Exchange. Primitive society had little commerce, for each group was self-sustaining on its own limited resources. Producer and consumer were identical, or at least in close personal relationship with each other. Production was for use and not for market. Division of labor deepened as commerce widened; a household economy expanded into a tribal, manorial, or a village economy. As these local economies further broadened into a national and, finally, into an international economy, specialization was correspondingly intensified. Specialists traded their own commodities and services for the different products of other distant specialists.

As trade became more extensive, a specialized group of middlemen, or merchants, appeared; markets sprang up at convenient places of exchange; and recognized rules of trade were followed. Barter, or a simple exchange of goods for goods, gave way to a money economy, and, finally, to one of money and credit. Merchants, markets, and money, the three M's of trade, constituted the who, where, and how of exchange.

This chapter will treat markets and middlemen; the next chapter will discuss the factors of financial risk and uncertainty in our complicated system of specialization and exchange. The chapters which follow in Parts Three and Four will be devoted to the mechanism of money and credit and to certain problems of domestic and foreign exchange.

4–2. Development of Markets and Middlemen. Feudalism was a military system of land tenure under which the warrior classes exploited the working masses. As the medieval manor was economically self-sufficient, there was little exchange between it and other similar communities. Feudal obligations were generally paid, not in money, but in commodities and services. Merchants were few and markets were small.

Development of the handicrafts and a revival of trade converted the manorial village into the medieval town. The earliest commerce was that between the artisans of these towns and the agricultural peasants of the surrounding country. Each large town had its market place and its market day; raw materials were traded for finished goods. A middle class of burghers or merchants developed.

Medieval manufacture and commerce were in the hands of craft guilds and merchant guilds. Many guildsmen were both the makers and the

merchants of their wares. Great fairs were held several times a year at specially designated towns. Some were national and even international in scope. They may be viewed as the crude beginnings of organized exchanges.

The coming in of capitalism, defined in Chap. I, took place in the Renaissance towns of northern Italy in the transition period between the medieval Crusades and the modern era of geographical expansion. It was featured by a revival of commerce, growth of towns, wider use of money, and an increased number of middlemen. Itinerant merchants distributed their wares along the old trade routes of Europe; these pack-bearing peddlers were the earliest capitalists. With the decline of the guilds, specialized middlemen assumed their merchandising functions; they coordinated hand manufacture at home of various goods in different stages of production.

As the commerce of the medieval city-states became more extensive, organized markets and credit instruments came into being. The goldsmiths and money changers of the Lombard towns of northern Italy became the bankers of the Mediterranean world; the merchants of Venice connected the Orient with the Occident. The Hanseatic League similarly coordinated the commerce of the Rhineland and the Baltic towns of northern Europe. With the development of national states great trading companies, such as the British East India Company, came into existence.

After the Industrial Revolution, also explained in Chap. I, specialization became more intensive and commerce more extensive. National markets broadened into world markets. Functional middlemen facilitated the exchange of products between distant lands and diverse occupations; they coordinated different stages in an industry. Not only were there specialized manufacturers of different goods, but also specialized merchants at wholesale or retail. An ever-increasing number of middlemen thrust themselves between the farmer and the processor, the manufacturer and the consumer, as production became more specialized and roundabout. Some were primarily merchants, but others became specialists in such related functions as storage, transportation, and insurance.

4–3. Merchants as Primary Middlemen. The primary middleman is the merchant, for he discovers, creates, and organizes markets. His chief function is the correlation of the diverse forces of supply and demand in an impersonal and highly specialized economy of markets and prices.

a. Types of Merchant. To this group of primary middlemen belong wholesalers, retailers, and jobbers. Strictly speaking, the jobber is a merchant who specializes in odd lots, but the term is often regarded as synonymous with wholesaler.

The retailer makes more attractive the goods consumers buy. He helps to educate prospective customers by displaying or advertising new goods,

the existence of which otherwise they might never have known. He makes the purchasing process more convenient by assembling in one store a large variety of goods.

A department store sells various kinds of articles under one roof, whereas a specialty shop limits its retailing to one type, or several related types, of goods. Chain stores are multiple, similar outlets in different locations under a single administration.

Advertising is a specialized field within the broad occupation of merchandising. Its purpose is the creation of demands for particular products, not the gratification of existing wants in the wisest ways. Whereas a salesman sells to a single purchaser or to a few prospects, the advertiser seeks to stimulate general sales to innumerable, unknown, potential customers. Somewhere between these two extremes is the mail-order business.

b. Types of Utility Created. A common distinction is that between the merchant and the manufacturer: one is apt to say that the latter makes goods, while the former sells them. It is essential, however, that the economist's definition of production be kept in mind. Production does not consist in the creation of matter, for that is a scientific impossibility. It consists rather in the creation of utilities, *i.e.*, want-gratifying qualities in commodities or services.

The manufacturer creates form utilities in such goods as furniture by bringing together materials like wood, metal, glue, paint, etc., and fashioning them into finished articles ready for consumption. The merchant, whether wholesale or retail, creates place, time, and possession utilities by transportation, storage, and salesmanship. He brings economic goods to places, times, and persons, where, when, and by whom they are most desired. Hence, both merchant and manufacturer are productive, although in different ways.

4-4. Elimination of Middlemen. The functions and hazards of the merchant are not fully appreciated. Hence, the frequent suggestion that he be eliminated. It is possible to do so, but the desirability of such action is dubious. Merchandising is necessary under our system of specialization and exchange. The elimination of the middleman would necessitate the absorption of his functions by the manufacturer or farmer; it would merely restrict specialization.

Cooperative associations dispense with such middlemen as commission merchants by selling their produce through their own organizations and agencies. Some farmers conduct roadside stands for the sale of fruits and vegetables to automobilists; their prices are only slightly, if any, lower than those in the stores, for they must market as well as grow their produce. Some large manufacturers sell their products directly to consumers by conducting their own retail departments or mail-order busi-

nesses. Their slogan, true or false, is "Buy directly from the manufacturer and save the middleman's profit." Such movements swing back from specialization to the integration of industry. These businessmen must absorb in the prices of their goods merchandising expenses as well as manufacturing costs.

Stimulated by the gain motive, merchants operate on private enterprise under the competitive system. A socialized economy, on the contrary, would coordinate industry by planned production and controlled consumption through public agencies. Individual middlemen and private profits would disappear. It is not so clear, however, that prices would be lowered, quality of goods raised, and merchandising service improved.

4–5. Functions of Merchants. *a. Coordination.* If division of labor is to result in cooperation instead of confusion, coordination in the labors of various specialists is required. This important work is now done by various groups of merchants who are specialists in organizing markets.

The aim of the merchant is to facilitate commerce and to direct it into profitable channels. He connects the farmer with the manufacturer, and the manufacturer with the consumer, acting as a canal between, and a reservoir for, different trades and various stages of production. To be sure, the middleman charges for his services of coordination by exacting a heavy toll from the rich flow of commodities passing through his hands.

b. Assumption of Price Uncertainty. Another function of the middleman, in addition to that of coordination, is his assumption of some financial hazards of production. A wholesale merchant, for example, may buy in advance the whole crop of a farmer or the entire output of a mill. Farmers and manufacturers are thus assured in advance of a certain market, and sometimes of a definite price, for their products.

The wholesale merchant is a shock absorber in an industrial society characterized by hazardous production in anticipation of demand. The ultimate consumer buys from his retailer in accordance with his individual needs. The retailer, in turn, replenishes his stock from that of the wholesaler, who is forced to keep on hand a relatively large inventory in order to meet the continuous but changing demands of the market.

Small enterprises are loath to engage in manufacture without definite marketing prospects; they prefer some guarantee of a future market before investing their capital. Functional middlemen may offer these manufacturers contracts for the future delivery of their goods at specified prices, which should cover their costs of production and allow a nominal profit. The wholesaler, jobber, or some other merchant is often willing to assume this merchandising hazard. If he has estimated the market price correctly, and the demand for a particular good is maintained, he will make large profits; if his guess is inaccurate, or if prices fall, he will incur losses.

Hence the merchant may be said to protect, as well as to direct, the production process. His net profit is comparable to an insurance charge. Gross profits are often offset by heavy losses.

4–6. Costs of Merchandising. The number of merchants may be excessive, and their strategic position may yield exorbitant charges for their services. Consumers feel this pressure in the high prices asked for consumption goods. Farmers have complained that prices received from middlemen for produce are too low to cover their costs. In short, the spread in price, commonly called "mark-up," seems so great that the charges of middlemen appear disproportionately large.

It cannot be denied that the merchant does perform important economic functions. He helps the consumer to get what he wants, when he wants it, and in the desired form and quantity. He also helps the farmer and the manufacturer to dispose of the goods that they have grown or manufactured. The present industrial system is so complex that the consumer would find it difficult to purchase directly all the goods that he desires. Again, the farmer and the manufacturer are so busy with their particular tasks that they have neither the time nor the ability to search out ultimate consumers.

Finally, marketing is an expensive process; it is not deliberately made so by middlemen. The costs of packing commodities and of serving people by modern standards are high. Wastes from the spoilage of goods and changes in fashion are great. Marketing charges must be high enough to cover these uncertainties and to permit profits to balance losses.

4–7. Functional Middlemen. The ordinary merchant selling for himself at wholesale or retail may be regarded as the primary middleman. Secondary middlemen are referred to as functional, or technical, middlemen. They perform certain specialized services in the complicated process of roundabout production, such as the creation of credit, the assumption of particular risks, or the storage and transportation of commodities. Illustrations of functional middlemen are bankers, brokers, warehousers, and truckers.

The growth of commerce and specialization have made marketing a complex process, involving the transportation of goods from all quarters of the globe, their assembly and classification in great distribution centers, their storage between seasons, and, finally, their sale to ultimate consumers. It is a far cry back to the medieval peddler who anticipated the modern middleman before the present era of specialization. The variety and quality of goods sold have improved; the number of commodities and services bought has increased.

A discussion of markets and middlemen would be incomplete without mention of underwriters who sell insurance against financial loss through such physical hazards as fire and flood, and dealers in futures, whose

market speculation affords manufacturers facilities for price protection by hedging. These matters will be discussed in more detail in the following chapter.

4–8. Brokers and Commission Merchants. The usefulness of the banker, the insurance company, and the railroad is generally acknowledged. The productivity of brokers, who handle transactions in stock or produce or real estate, is more frequently questioned.

The broker, as contrasted with the merchant, buys and sells not for himself, but in response to orders from his clients. The intricacy of modern stock exchanges and commodity markets necessitates the existence of such specialized middlemen. The conveyance of real estate likewise requires care, confidence, and experience.

The commission merchant performs a similar function. He receives produce from the farmer and sells it for the highest possible price, keeping for himself a certain agreed-upon percentage as his commission. His intimate knowledge of the market facilitates the diversion of produce from glutted markets to more profitable ones. In addition, the commission merchant classifies and stores produce. He also puts into more marketable form the goods that pass through his hands.

4–9. Price as an Organizing Factor. The price system is the automatic regulator of production and consumption in our economy. A high price encourages production and discourages consumption; a low price does the reverse. Through the process of exchange a good tends to flow from a low price area, where it is plentiful, to a high price area, where it is scarce.

Price is the great barometer that economic navigators study; they seek to follow, or to anticipate, price changes. The coordination of production by different and distant specialists is achieved by middlemen under the stimulus of private profits, through the channels of organized markets, and by the automatic operation of the price mechanism.

Our roundabout system of production requires that manufacture be carried on in anticipation of demand. In the absence of a central authority for advance planning, reliance is placed upon individual initiative to stimulate and to organize production. In spite of much waste, many maladjustments, and frequent misdirection of production, the various and varying demands of consumers are generally and ultimately gratified under our system of free enterprise.

4–10. Economic Readjustments through Price. Changes in fashion and in wants of consumers upset market demands, while changes in techniques alter costs and conditions of supply. Both forces tend to disturb prices, unless one influence just negates the other. In addition to changes in the relative values of individual goods, there may be a rise or fall in the general price level, *i.e.*, a change in the purchasing power of money.

Price adjustments are automatic in that a high price stimulates the production of that good for which there is an increased demand or an unusual shortage. In the long run, however, the price of an expensive good will fall as its stock is increased. A low price, in turn, decreases the production of that good by driving out of business marginal or less efficient producers; eventually, its price tends to return to a higher level. Thus, there are "snowbird" mines, which operate when the price of coal is high but close down when its price is low. Most manufacturers have excess capacity that is utilized only under conditions of great demand. If this were not so, price fluctuations would be even greater than they are now.

4–11. Price Stabilization. Modern transportation facilities can move goods quickly from areas of abundance to places of need; better refrigeration and improved storage devices can hold goods over from periods of plenty to periods of scarcity. Such mobility over place and time did not exist generations ago, nor is it possible now in backward countries. Hence, there was great suffering from famine in past times, as there still is today in primitive communities. The conquest of space and time by improved means of transportation and storage has reduced differences and fluctuations in price. A local and temporary surplus of goods need not be sold where and when it is produced.

Prices may be stabilized also by the professional activities of middlemen. The profits motive impels merchants to buy goods where and when they are regarded as cheap, and to sell them where and when they are believed to be dear. Thus, the difference of a few cents a ton in the price of steel above its transportation costs tends to move that commodity from Germany to England. The difference of a few cents a bushel over its expenses of storage will be sufficient to hold an elevator of wheat over from May to September.

Price differences in various places and price fluctuations over periods of time are minimized by the buying and selling activities of successful middlemen, but they are magnified by the unsuccessful operations of outsiders who gamble on the market. Bargain buying by middlemen, where and when prices are low, raises prices; conversely, their selling for profit at high levels lowers prices. Although prompted by a selfish desire for pecuniary gain from their market activities, middlemen protect society from even wider differences and wilder fluctuations in price than would otherwise prevail without their professional arbitrage and speculation.

A change in price has either a restraining or a stimulating influence on business. A future scarcity is apt to be anticipated by rising prices, which, in turn, increase production and decrease consumption. The reverse is equally true; a prospective abundance is reflected in falling prices, which depress the production of those goods and increase their consumption. The delicate mechanism of price discounts future development

unless disturbed by inaccurate forecasts or excessive speculation. By such price discounting of the future in the present market, a gradual adjustment of industry to new conditions takes place instead of a series of sudden and sharp readjustments to unforeseen developments.

Chart 3 illustrates how the successful market activities of middlemen

CHART 3. Reduction of price differences and price changes by arbitrage and speculation of successful middlemen. The dashed line indicates price without arbitrage and speculation, and the solid line pictures reduced differences and reduced changes in price because of these activities.

stabilize prices. Let us now define some technical terms and examine these operations more closely.

4–12. Speculation and Arbitrage. Speculation is buying or selling in the present market in anticipation of price changes and performing the reverse operation in a future market, making profit or taking loss from price changes between those opposite actions at different times.

The more familiar form of speculation is to buy in the present market and to sell in the future, hoping to profit by a rise in price. The reverse also is possible, *i.e.*, selling in the present and buying in the future, hoping to profit by a fall in price. In the first case, the speculator is bullish or long on the market; in the second case, he is bearish or short on the market. Short selling will be explained later in this chapter.

Arbitrage is the simultaneous buying and selling in different markets because of price differences therein in excess of transportation costs. For illustration, a broker might buy 1,000 bushels of wheat in Chicago at \$1.90 a bushel and sell immediately 500 bushels in New York for \$1.94 a bushel and 500 bushels in Philadelphia for \$1.96 a bushel.

The purpose of arbitrage, like that of speculation, is profit; but its source lies in the existence of simultaneous price differences in various markets, instead of in price changes over a period of time in the same market. Arbitrage reduces price differences in various localities, just as successful speculation reduces price changes over a period of time. The arbitrager does not hold his commodity or security for a rise in price; instead, he attempts to sell it immediately in another market at a higher level. The arbitrager is the watchful hawk of markets, whose activities tend to keep price differences in various localities down to the bare minimum of transportation charges and insurance costs.

4–13. Dealings in Futures. Warehouse receipts for such staples as wheat and cotton can be bought and sold. This permits arbitrage and

speculation to take place while the commodities themselves remain undisturbed in storage. Meanwhile their prices may fluctuate and their titles of ownership can change hands.

It is possible also to buy or sell for future delivery. In other words, commodities not yet raised or ripened can be traded. A buyer may agree to take possession of, or a seller may contract to deliver a certain amount of, a particular commodity at some specified future time at a presently agreed upon price and place. Such future contracts, which are really present commitments for future acceptance or delivery, are so indicated, as, for example, September wheat or July cotton. In contrast, present trading for immediate acceptance or delivery is called a "spot" transaction.

Some middlemen are professional speculators who trade continuously both ways in numerous transactions. Such traders will buy futures whenever they seem unreasonably low; they will also sell futures whenever they are higher than their own judgment indicates that conditions warrant. If the price estimates of these speculators come closer to later spot prices than current prices in the future market, these successful speculators will profit from their shrewd operations; otherwise losses will result from their rash market activities. In any event, their continuous trading in futures permits manufacturers and farmers to shift to these professional speculators much of the uncertainty of price changes.

4–14. Nature of Markets. To the average person a market is a place where tradesmen fill baskets with food. In its economic sense, however, a market is a meeting of the forces of supply and demand for the determination of price. From this definition of a market there follows the so-called "law of market price," *i.e.*, that within a perfect market, at a given time, and for a particular commodity or service, only one price will prevail. If more than one price exists for the same commodity at the same time, there must be more than one set of supply and demand forces, and, hence, more than one market. It is more likely, however, that the differently priced goods are similar but not the same in character. Indeed, we may define a perfect market as a place or a condition in which one price exists at a given time for a particular article. A single set of supply and demand forces is at equilibrium.

Due allowance must be made for transportation charges, for a stated price is related to a certain place. Although the whole United States is one market for automobiles, and the price of a standard make of car is everywhere the same, it is generally quoted f.o.b., or "free on board," which means that the consumer must add the costs of transportation. On the other hand, a price quoted c.i.f., meaning "costs, insurance, and freight," includes transportation charges, *e.g.*, the price of copper delivered in the Connecticut valley.

There are markets for commodities, for securities, and for services. There are small, simple markets; there are also large, organized exchanges. The markets for such perishable commodities as milk and fresh vegetables are local, but the development of refrigerator cars has widened these community markets into regional markets. Markets for nonperishable staples, such as wheat and corn, are national or world markets. The price on the Chicago Board of Trade tends to dictate that on the smaller exchanges: slight differences above transportation charges are promptly eliminated by arbitrage. The New York Stock Exchange similarly dominates the market for securities, although there are other stock exchanges.

4–15. Factors in Development of Commodity Markets. Huge markets for grain, cotton, and other agricultural staples have developed through improvements in communication, transportation, and storage. The invention of the telegraph, the telephone, and the radio have created an economic nervous system; and the inventions of the steamboat, the railroad, and the automobile have provided the circulatory system of our economy. To follow through this same figure of speech, increased and improved marketing facilities have aided the digestion and assimilation of our economic surpluses of agricultural products.

The immediate stimulus to the development of produce exchanges was the existence of large stocks of agricultural staples, which were produced for market sale and not for home consumption. Improved methods of storage permitted these stocks of agricultural commodities to accumulate at important transportation centers. Grain elevators and cotton warehouses necessitated organized markets where warehouse receipts could be bought and sold with ease and safety.

Functional middlemen began to specialize in marketing agricultural products and in trading their present or future titles. Although farmers are generally anxious to turn harvested grain or cotton into funds as soon as possible, the miller of flour or the manufacturer of textiles is often reluctant to purchase in advance a year's stock of his essential raw materials. This assumption of price uncertainty is done by specialized middlemen, who buy warehouse receipts of grain, cotton, and other agricultural staples.

Produce exchanges developed in response to the need for promptness, convenience, and certainty in buying and selling these commodities. A closer organization of traders and better facilities for trading were accompanied by stricter rules for admission and higher standards of conduct of members.

4–16. Illustrations of Important Exchanges. Produce exchanges have been given different names, such as "boards of trade," "chambers of commerce," and "bourses." Their common object is the standardization and regulation of conditions of exchange. Produce exchanges may be general

or specialized in character; *i.e.*, they may deal in many agricultural staples or their trading may be limited to some one or several related commodities.

The origin of produce exchanges may be traced to the fairs of medieval Europe. The Antwerp Bourse was established as early as the sixteenth century, and the Royal Exchange of London was organized shortly afterward. Certificates of ownership on approved forms were bought and sold. This implies the existence of credit and of responsible officers of the exchange. As produce was sometimes purchased by sample and even by certification, traders must have had assurances that the goods to be delivered later were as previously described.

The Chicago Board of Trade, organized in 1848, is the most important commodity exchange in the United States. It dominates the national wheat market as well as that for other grains. The Merchants' Exchange of St. Louis and the Minneapolis Chamber of Commerce are similar to the Chicago Board of Trade, but of less importance. The New York Produce Exchange has been in existence since the middle of the last century. There are many specialized exchanges, such as the New York Cotton Exchange and the New York Coffee Exchange. There are numerous, important foreign exchanges, such as the Liverpool Exchange, on which much of the world's cotton has long been traded. Other general or specialized produce exchanges, differing in character and importance, exist in all large cities of the world.

4–17. Nature of Commodity Exchanges. Exchanges are organized market places in which individuals, or rather their brokers, buy and sell titles to various commodities. Warehouse receipts, not the goods themselves, change hands. Again, dealings in futures take place, as well as the buying and selling of "spot" commodities for immediate delivery.

The exchange itself does not engage in trading but merely affords a convenient place for its members to buy and sell under recognized rules. It is not operated for profit and does not regulate the prices of commodities traded on its floor. The exchange provides adequate facilities and promotes uniform practices. Its regulations seek merely fair and orderly trading. With these ends in view, it is commonly required that individuals buy and sell on the exchange only through brokers who are members of the exchange and whose operations are governed by the written regulations and the unwritten customs of the exchange. Limitation of trading to members of the exchange permits enforcement of its regulations by suspension or expulsion of offending traders.

Produce exchanges are frequently misunderstood; they have been popular targets for public abuse. Some of this criticism is justified, but much of it is uninformed, or unfair, or both. Exchanges have been held responsible for high prices and monopolistic practices. They have been

regarded as speculative institutions in which wicked people gamble on the necessities of life. Before discussing these alleged evils of produce exchanges, however, let us observe their operations and functions.

4-18. Purchase by Sample and Sale by Description. The produce traded on commodity exchanges must be one of the great agricultural staples for which there is a steady demand. The commodity cannot be perishable; *i.e.*, it must be capable of transportation and storage without deterioration. Finally, the produce must be easy to standardize or classify.

Meats, fruits, and vegetables have a steady demand, but they require refrigeration. Although there are definite grades recognized by the trade, such as "prime" and "fancy," these grades are not so clear as the classes of staples, *e.g.*, winter wheat Number 2. Meats, fruits, and vegetables are sold by commission merchants on reputable markets, but not on organized exchanges. Again, they are more apt to be bought on sight and by possession, rather than by type and title. Tobacco is sold by lots at auction.

The standardization of agricultural staples makes it possible to sell them by description and to purchase them by sample through brokers on organized exchanges. Individuals may speculate in the price of wheat without actually seeing the produce itself, and certificates of deposit of a certain amount of cotton of a specific type and grade can be bought and sold like stocks and bonds. Its price may go up or down, but the quality and quantity of the commodity are as stated in its warehouse receipt.

4-19. Marketing Agricultural Staples. Let us illustrate the general process. A farmer harvests his wheat crop and sends it to a local grain elevator. The wheat is typed, graded, and measured before it is stored. Thus, it may be 2,000 bushels of Northern Spring Wheat Number 1, according to its kind and quality. An entire carload may be classified by what is known as "sampling." A long, hollow tube is thrust down to the very bottom of the car, and the contents of this tube are then carefully inspected. In this way it is difficult to conceal waste, dirt, or grain of inferior quality.

Farmers have sometimes contended that such classification of their produce has not been done fairly; hence, governmental inspectors are often required by law. In some states, officials of local boards of trade either perform or supervise this produce classification. When the grain is moved to another warehouse or purchased by a miller, it is again inspected to see that the stated quality has not deteriorated and that the certified quantity has been delivered.

The farmer may be paid immediately for his grain or he may receive warehouse receipts for a certain number of bushels of a given type of wheat. He may hold these produce certificates in hope of a higher price. Meanwhile he can use them as collateral for a bank loan. At any time, the

farmer can sell these paper claims on wheat to grain brokers or their clients, who are always willing to buy them at what they consider favorable prices. From this group of functional middlemen the miller buys warehouse receipts and calls immediately for delivery of the grain, if a spot transaction, or at the time stipulated, if bought for future delivery.

4–20. Functions of Produce Exchanges. Produce exchanges afford a convenient and continuous market for buyers and sellers. Although crop harvests are periodic and uncertain, claims to possession can be bought or sold at any time. There is a steady demand from consumers for all agricultural staples and millions of people are engaged in raising them. Produce exchanges furnish a ready and reliable market to buying millers and manufacturers, as well as to selling farmers and trading speculators.

Produce exchanges give mobility to crops; *i.e.*, warehouse receipts, not the grain or cotton itself, circulate in the same way that silver certificates circulate instead of the bullion which is held against them in the Treasury at Washington. Warehouse receipts are as marketable as stocks and bonds; they can be bought or sold quickly and easily through reputable brokers. Their present and future delivery prices are available in the latest newspaper quotations. Warehouse certificates, as just stated, can be used as collateral for bank loans.

Produce exchanges are clearinghouses of information. Brokers are continually studying conditions of supply and demand and all those influences which cause fluctuations in price. The produce exchange disseminates much of this information, but it makes little organized effort to interpret factual findings or quoted opinions. The actions of individual traders and the activities of organized groups, known as pools, are reflected in buying and selling movements, with consequent price fluctuations.

Finally, the trading of functional middlemen on commodity exchanges may stabilize prices and influence the rate at which staples are produced and consumed. The prospect of a future scarcity of wheat, for illustration, is reflected in present quotations on the exchange; its price tends to rise slowly, instead of jumping rapidly, unless a crop failure suddenly threatens or wild speculation prevails. When the anticipated scarcity does occur, it has already been partially or excessively discounted by the market. The rising price of wheat, moreover, has so stimulated its production that a bumper crop may be expected at the next harvest. The high price of wheat also has encouraged its importation and discouraged its consumption.

4–21. Stock Exchanges. Stock exchanges are organized markets for buying and selling securities, just as produce exchanges are organized markets for buying and selling warehouse receipts. Stock exchanges are markets for investment capital in industry, rather than in farm commod-

ities. The growth of stock exchanges was stimulated by the popularization of the corporate form of business, just as produce exchanges developed for the disposal of agricultural surpluses.

The New York Stock Exchange, known as the "Big Board," dominates the national and international markets for its listed stocks and bonds. There is also the New York Curb Exchange, which has a different list of securities and its own member brokers. Stock exchanges of less importance are located in other cities. Thus, there are the Philadelphia, Chicago, Boston, Salt Lake City, San Francisco, and Los Angeles exchanges, each possessing its own list of securities, its own membership of brokers, and its own regulations for trading. The Stock Exchange of Toronto and the securities exchanges of the great cities of Europe also are important investment capital markets.

Many securities are not listed on the New York Stock Exchange, the New York Curb, or the smaller exchanges of other cities. Application may never have been made for the listing of these securities, or their listing may have been refused by the exchanges. Unlisted securities may be of questionable character; but they also include sound securities issued in small amounts and held rather closely.

Securities not listed on any stock exchange may be traded directly by brokers in what are known as "over-the-counter" transactions. Their daily bid and asked prices are published in financial sheets. Prices quoted on a stock exchange are records of actual transactions at the opening and closing of the market; the highest and lowest prices of the day also are generally reported.

4–22. Development of the New York Stock Exchange. Although the New York Stock Exchange did not become a powerful financial institution until after the Civil War, its history is almost as long as that of the American Republic. Indeed, shortly after the Revolutionary War, a dozen men were accustomed to meet under a tree on Wall Street in New York for the purpose of buying and selling government bonds for themselves or their friends. Twenty-four such brokers, in 1792, signed an agreement with respect to commissions and mutual obligations. In 1817, these original street brokers took a room on Wall Street and adopted a constitution. In this original constitution, fictitious sales were forbidden under pain of expulsion.

In 1863, the New York Stock Exchange Building Company was organized to provide a more commodious home, which was sorely needed because of the great increase in its business. Since that time, further expansion has been repeatedly necessary. Whereas in former years million-share days on the floor of the New York Stock Exchange were unusual, they now are common. In the fall of 1929, there was a record-breaking day, during which over 16 million shares of stock changed hands.

In number and value of securities listed, and in volume of transactions recorded, the New York Stock Exchange exceeds the total of all other stock exchanges. New York has become the financial center of the world; the international dominance of Wall Street is due largely to the importance of the New York Stock Exchange. Its transactions and influence now exceed those of Lombard Street, London, which was formerly the capital market of the globe.

4–23. Organization of the New York Stock Exchange. The New York Stock Exchange is an unincorporated association with over a thousand members. As it deals in the securities of the entire nation, its membership includes individuals or firms from all parts of the country. Large brokers in other important cities either possess seats on the New York Stock Exchange or maintain professional relations with some New York member who conducts their trading for them. Membership on the New York Stock Exchange is limited, and a broker who desires a seat thereon can obtain it only by purchase from some present member with permission of the entire body. These seats on the New York Stock Exchange are worth large sums of money; recent transfers have run into hundreds of thousands of dollars each.

Only members of the New York Stock Exchange can use its facilities. Other individuals must employ some member of the exchange to act as broker for them. Speculators and investors tell their brokers what securities to buy or to sell, in what quantity, and at what price. The broker endeavors to carry out the instructions of his client. If successful in making a purchase or a sale at the stipulated price, he charges a broker's commission in accordance with an established schedule of rates. An individual may sometimes order his broker to buy or sell a security "on the market," *i.e.*, at the current price, whatever that may be.

The purpose of the New York Stock Exchange is to facilitate the purchase and sale of securities. The constitution adopted in 1902 states that "its objects shall be to furnish exchange rooms and other facilities for the convenient transaction of their business as brokers; to maintain high standards of commercial honor and integrity among its members; and to promote and inculcate just and equitable principles of trade and business."

The New York Stock Exchange strives to maintain the rules of that institution and the integrity of the brokerage business. A member who is convicted of fraud is expelled, and a member who is unable to fulfill his contracts is suspended. The organization maintains a list of securities that may be bought and sold on the floor of the exchange, and transactions thereon in other securities are forbidden. The purpose of this restriction is the elimination of questionable securities from its trading; and to that end, before any stock or bond can be listed on the New York

Stock Exchange, it must be passed on by a special committee. The exchange does not guarantee the character of all those securities which it lists, but it does seek to eliminate those which are obviously fraudulent.

4–24. Functions of Stock Exchanges. Stock exchanges facilitate the investment or withdrawal of funds and the exchange of securities. They afford a continuous and convenient market for the purchase or sale of stocks and bonds. Stock exchanges give mobility to corporate capital in the same way that produce exchanges give mobility to agricultural products. Securities can change ownership without disturbance to the business or corporate capital represented by these credit instruments. They can be used as collateral for loans and as a basis for the extension of credit.

The stock exchange also throws the searchlight of publicity on securities traded thereon, or at least on their prices. One can easily follow the market values of those stocks listed on the New York Stock Exchange by their latest quotations. Their market prices are immediately available over the ticker; they are later published in newspapers. The security market is a barometer of business in general, as well as of particular ventures. There is the same likelihood of anticipating future business developments by the stock market as of discounting future crop prospects by the commodity market.

4–25. Trading on Stock Exchanges. To the uninitiated, the trading on the New York Stock Exchange and the Chicago Board of Trade seems very confusing. Their apparent turmoil affords a striking contrast to the quiet, systematic operation of a large, well-ordered bank. Just as the produce exchange has its various "pits," in which spirited trading takes place in different kinds of produce, so the floor of the New York Stock Exchange is similarly marked by different posts devoted to transactions in particular types of securities.

The floor broker literally goes about from pillar to post in his efforts to execute the buying and selling orders of his clients. He offers to buy a certain number of shares of a particular stock at a named price. He may also be authorized to offer that security for sale at a particular price or within a certain range of prices. If he finds no taker, our floor broker moves off to execute another order and returns later in the hope of finding a taker of his original offer. The broker may be permitted a certain amount of latitude by his client, or he may possess several orders, perhaps of opposite type, at different prices. If so, he lowers the price to sell, or raises the price to buy, until another broker may accept his offer at a given figure. The prices are raised or lowered in terms of points, each one of which represents a dollar. Fractions are recognized only in terms of halves, quarters, eighths, etc.

When an offer to buy or to sell is accepted, each of the two brokers makes a note of it on a special pad. For illustration, A records the sale to B of 100 shares of XYZ stock at a particular price, and B records the same purchase from A at the same price. Although no agreements of sale are drawn up, these informal bids and acceptances are as effective as formal written contracts. When there are several acceptances or offers, the first to be heard is the one that is regarded as binding. Consequently, a loud voice is as necessary to a floor broker as active legs.

There are numerous telephones in stalls about the trading room by which each member of the exchange has immediate access to his own office. He is constantly receiving new orders to buy or to sell, and changes or cancellations of unfilled orders. Out-of-town brokers may have trunk wires to the office of some New York brokerage house, which, having a seat on the New York Exchange, can execute the orders of the clients of its correspondent brokers in distant cities. The broker tape records quotations from the New York Stock Exchange by telegraph. Prices on the "Big Board" are soon posted in little board rooms throughout the country.

4-26. Regulating Activities and Clearing Accounts. The activities of brokers are regulated by the rules of the stock exchange. Rates of commission are fixed and brokers may not charge more or less than the stipulated percentage or amount. Trading takes place in lots of one hundred shares. Orders of less than one hundred shares are ordinarily turned over to brokers who specialize in odd lots. These brokers hold such orders until they accumulate to a full hundred. A slightly higher commission is charged for this special service of assembling and executing odd-lot orders.

Promptness in the delivery of securities is required by the New York Stock Exchange, a process which is facilitated by the existence of its own clearinghouse. For each security that changes hands there must be a buyer and a seller, represented by two brokers, both of whom are members of the exchange. The total number of shares sold must equal the total number of shares bought; dollar receipts must balance dollar costs after allowance for commissions and taxes. At the close of each day's business, every broker reports those securities he has sold and records those he has bought. The difference between their total values is what he owes the clearinghouse or what the clearinghouse owes him. To balance accounts, the broker draws his check to the clearinghouse or receives a check from it.

4-27. Bulls, Bears, and Lambs. "Bulls," as indicated before, are those speculators who have "gone long" on the market, *i.e.*, they have bought securities which they hope to sell later at higher prices. "Bears" are those individuals who have "gone short" on the market, *i.e.*, they have sold securities, sometimes in hope of buying them back later at lower prices.

"Lambs" are innocent or uninformed speculators who are shorn of their golden fleece; they trade funds for experience.

The fact that many securities change hands so often shows the speculative character of much trading on the stock exchange. In a single year total sales or purchases on the New York Stock Exchange exceed the total value or volume of all listed securities.

4–28. Wash Sales and Bucket Shops. Wash sales are deliberately rigged, but they are actually executed on the floor of the exchange. A straw man puts through a transaction to another dummy. Sometimes one individual sells to another, who, in turn, resells to the original owner. This process can be continued indefinitely without great capital and without much danger of loss, but with a sinister influence on price. The purpose of wash sales is to make a profit by inflating or depressing the value of a particular security. Although forbidden by the rules of most exchanges, which provide heavy penalties therefor, wash sales are difficult to detect and hard to prevent.

The proprietor of a bucket shop receives the deposits of his "long" patrons and places them as bets against the deposits of his "short" patrons. His position is similar to that of a bookmaker at a horse race, for bucketing is essentially gambling. The bucket-shop proprietor is not a broker who executes the orders of his clients on the floor of the exchange, because there are neither buyers nor sellers, for there is no real trader. Indeed a broker who engages in bucketing is denied membership in the stock exchange. Bucket shops are illegal gambling establishments, forbidden by the laws of most states.

4–29. Buying Stock on Margin. A conditional claim on a larger number of shares can be had by buying stock on margin, instead of absolute ownership of a smaller number. The broker furnishes the additional funds, but he holds the securities of his customer as collateral for his loan. The legal pretext for buying stock on margin is that the purchaser is obtaining his securities by installment payments. The broker is merely financing their purchase until his client can pay off his remaining indebtedness. In most cases, however, stocks bought on margin are soon sold and never paid for in full. This situation, therefore, is not comparable to buying a home with a mortgage or to purchasing an automobile on time, for these goods are bought for immediate possession and for long-term use, not for short-term speculative profit.

Buying stocks or commodities on margin is risky and dangerous, because the possibility of multiplying one's loss is as great as that of multiplying one's gain. A decline of several points can reduce the speculator's margin to such an extent that the broker, fearing for his own safety, demands more funds to restore the margin. If these are unavailable, the broker is forced to sell out his customer who had bought on margin, in

order to save borrowed funds and to collect interest and brokerage fees. The broker obtains his loanable funds chiefly from the call money of banks, and this money must be paid on demand. It is not the stock exchange, but the individual speculator and his broker who foster buying stocks on margin. The broker plays the part of banker as well as broker in the same transaction.

The amount of margin required has varied with the individual, the security purchased, and the general condition of the market. Perhaps 80 per cent of the market value of a listed security was a fair generalization as to the limit of a broker's loan before 1929. Since that time, however, both practical experience and Federal regulation have pointed toward more conservative broker's loans and more extensive margins. Payment in full was required for low-priced stocks and at least half payment equity was demanded for other higher priced stocks. In 1946, buying any stock on margin was prohibited and full cash payment was required for all stock purchases. Subsequently, a 25 per cent loan was permitted on some listed stocks.

4–30. Selling Short. A speculator who is short on the market expects a fall in price. How can one attempt to profit thereby even though one does not own shares of stock? The answer is found in the process of selling short.

The short seller agrees to sell at the present price a certain number of shares of stock, even though he does not own them at the time of his sale. He hopes to be able to buy them in the future at a lower price and thus to cover at a profit his earlier short sale, *i.e.*, to buy for delivery what he had previously sold at a higher price, but which he did not then own. As the stock exchange insists on prompt delivery of securities which have been sold, the broker must furnish a stock certificate to the legitimate buyer who has purchased stock from the short seller. Stock certificates, which are not registered, are loaned by their owners to the broker who is thereby enabled to make prompt delivery. When a short sale has been covered by a later purchase, the borrowed security or an equivalent one is returned to its lender. The speculator who covers his previous short sale by a subsequent purchase does not get this stock certificate, for he did not deliver one when he originally sold it short.

In order to protect the broker and the owner of the borrowed security, the short seller, who does not possess what he has sold, must advance a certain amount of money, *i.e.*, a margin, as evidence of his ability to cover later; that is, to purchase stock in order to fulfill his previously made selling contract. If its price rises, the short seller must correspondingly increase his margin, because it has become more expensive to cover his previous short sale by a later purchase. If unable to supply additional margin, the short seller would be bought out in a rising market, just as the

buyer on margin would be sold out in a falling market. Short selling, like buying on margin, has been restricted by recent regulations.

4–31. Abuses of Organized Exchanges. Organized exchanges perform valuable economic functions, but their facilities have been abused. If feverish speculation prevails, trading on them disturbs, rather than steadies, prices; instead of revealing true business conditions, it conceals them.

Accessible machinery of organized markets makes it possible for an individual with funds to speculate on the future prices of commodities or securities. There are many gamblers who seek to "take a flyer" on the market. The result is sometimes disastrous to themselves and often unfortunate for society at large. These amateur speculators are ambitious enough to match their crude guesses against the careful estimates of professional speculators. Such speculation throws out of balance the delicate mechanism of price. Although occasionally and temporarily successful, outside speculators generally lose in the long run. In the meantime, their frantic buying or selling disturbs the market, usually by accentuating the prevalent price tendency, whether it be upward or downward.

One would not forbid the use of automobiles because criminals find them helpful in carrying out their robberies; nor can produce or stock markets be condemned because some people gamble on them. We must differentiate between the exchanges themselves and the activities of those individuals who misuse their facilities. It is difficult for the state to make and enforce criminal legislation without interference with individual liberty; it is equally difficult for the exchanges to make regulations which will restrain unsocial activities without limiting the freedom of legitimate businessmen and prudent investors.

4–32. Securities Exchange Act. The New Deal sought both to restrict speculation and to secure investment. Under Congressional power to regulate interstate commerce, trading on security markets was brought under the supervision of the national government. The Federal Securities Act of 1933, summarized in the last chapter, was followed by the Federal Securities Exchange Act of 1934. This law created a new Federal administrative body, known as the Securities and Exchange Commission. It consists of five members, not more than three of whom can belong to the same political party, appointed by the President and approved by the Senate. This Commission supervises investment banking, as the Federal Reserve Board does commercial banking.

The Securities and Exchange Commission was created in 1934 to supervise the registration of security issues and to suppress fraudulent practices in the sale of new securities, as defined in the Securities Act of 1933, outlined in the preceding chapter. It was further charged with the regulation

of trading in outstanding securities, both on stock exchanges and over-the-counter markets.

The Public Utility Holding Company Act of 1935, to be explained more fully in a later chapter devoted to public utilities, added the further responsibility of regulating the financial practices of holding-company systems of gas and electric corporations. The Securities and Exchange Commission was specifically charged with invoking the "death sentence" provision of that act which forbade pyramiding of holding companies in unrelated fields or in widely separated areas.

The Securities and Exchange Commission also was authorized to prepare advisory reports on plans of corporate reorganization after receivership in compliance with the National Bankruptcy Act. This duty was of especial significance in connection with the reorganization of many railroads which had been forced into bankruptcy during the depression years of the 1930's.

The Trust Indenture Act of 1939 charged the Securities and Exchange Commission with the supervision of new bond issues offered for sale. The Investment Company Act of 1940 brought investment companies and investment advisers specifically under its control.

In short, the Securities Exchange Act of 1934 and subsequent regulatory legislation expanded the scope of the Securities Act of 1933. It created a new Federal agency for the regulation of investment banking. The national government thus sought to eliminate fraud in the issuance of new securities and to prevent unfair practices in buying or selling securities already issued. The chief weapon of the SEC has been publicity through the requirements of registration of issues, certification of complete and correct information, and advance publication of essential information. Under its supervisory power, the SEC renders a favorable or unfavorable opinion on current practices and plans, which the courts generally accept as the opinion of responsible and disinterested experts.

Investment bankers have cooperated with the Securities and Exchange Commission to promote better corporate finance and to prevent prosecution for unfair practices. They have formulated their own codes of trade practices in conformity with the requirements of the law and the rulings of the SEC. Investment houses have endeavored to correct some of the most flagrant abuses of the past. The governing bodies of many security exchanges have revised their regulations to eliminate some objectionable trading practices.

All stock exchanges engaged in interstate commerce are now required to register with the SEC and to furnish that body with the required information, including copies of their constitutions and bylaws and, if incorporated, their articles of incorporation. They must also provide for the expulsion or suspension of members for conduct inconsistent with equi-

table principles of trade, or for willful violation of the Securities Exchange Act or rules of the Commission made in accordance therewith. Detailed information concerning their financial conditions and practices is required of corporations seeking reorganization or the issuance of new securities. Approval by the Commission and publication of a prospectus, as explained in the last chapter, likewise are necessary.

One of the chief objects of the Securities Exchange Act was restriction of speculation in stocks by an increase in margin requirements and the elimination of "shoestring" accounts. It provided that the Federal Reserve Board of Governors should supervise the extension of bank credit to brokers and, in turn, of brokers' credit to customers buying stocks on margin. Trading on produce exchanges was regulated by other Federal laws, such as that which set daily limits to price changes in a commodity traded on a produce exchange. It was hoped that deferring trading at a lower or higher price level until the next day might afford time to stabilize a demoralized or a "run-away" market.

Guide Questions on Text

1. *a.* Why is the merchant called the primary middleman?
   b. What economic functions does he perform?
2. *a.* Illustrate functional middlemen.
   b. What economic services do they perform?
3. *a.* How is price an organizing force in production?
   b. How is it a regulating factor in consumption?
4. *a.* Enumerate some forces making for changes in price.
   b. Explain some factors stabilizing price.
5. Define and compare speculation and arbitrage.
6. *a.* What is a market?
   b. What is a perfect market?
7. What factors have contributed to the establishment of organized exchanges? How? Why?
8. What are the chief features of organized exchanges?
9. What functions, if any, do produce exchanges perform?
10. Explain wash sales and bucket shops.
11. *a.* Explain buying on margin.
    b. Defend or criticize this practice.
12. *a.* Explain how and why one sells short.
    b. How does short covering cushion prices?
13. Would it be desirable to close stock markets temporarily or permanently? When? Why?
14. How did the Federal Securities Exchange Act of 1934 supplement the Federal Securities Act of 1933? What later changes have been made?
15. What later restrictions have been placed on trading on organized exchanges?

Topics for Investigation

1. Efforts and claims to eliminate the middleman.
2. Critique of price as an organizing factor.

3. Development of produce exchanges.
4. Constitution and regulations of the New York Stock Exchange.
5. Analysis of the prospectus of a new security issue.
6. Securities and Exchange Commission: origin, organization, and operation.

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CHAPTER V

BUSINESS RISKS AND UNCERTAINTIES

5–1. Increased Hazards of Industry. Modern life is beset with many dangers, and industrial society is no exception. Economic progress has been accompanied by increasing accidents. Automobiles and express trains are faster than horse-drawn vehicles, but they increase the hazards of travel. Modern technology has harnessed giant forces of nature, whose power to destroy life and limb is as great as their power to create utilities and leisure. The hazards of a company employee in a modern steel mill, fitted with overhead cranes and huge crucibles of molten steel, far exceed those of the village blacksmith of Longfellow's day.

The financial risks, like the physical dangers of industry, have been magnified and multiplied by economic progress. Capitalistic production is roundabout and in anticipation of demand, a fact which has increased the uncertainties of modern business. The growth of specialization has intensified the interdependence of all economic life. This likewise has increased the likelihood and the seriousness of misdirected production. Both the making and the marketing of goods are risky ventures fraught with many uncertainties. This chapter is devoted to the financial hazards of enterprisers and investors. A later chapter will discuss social insurance for the human risks of workers in industry.

5–2. Kinds of Hazard. The hazards of industry can be classified according to their sources, which lie in the physical environment, in the social organization, and in the individual himself. A flood illustrates the first type; a business depression, the second; and a foolish venture, the third type.

Just as there are human and property rights, so there are human and property risks. Death of the breadwinner is a human risk, but fire damage to one's house is a property risk.

The hazards of industry can be classified likewise as physical or financial, *i.e.*, those involving loss of actual product or those indicated by a decline in value. Fire is a physical hazard, which destroys or damages the thing itself, but a fall in price will deflate values without loss or even deterioration of the actual product. Indeed, monopolies have sometimes resorted to the device of destroying goods for the purpose of increasing their prices by creating an artificial scarcity.

The hazards of industry may be classified also as manufacturing or marketing uncertainties. Technological risks are those inherent in the long-run supply prospect, *i.e.*, in changes in methods or costs of production. Marketing uncertainties are those caused by changes in demand. Consumers may not demand an economic good so strongly as had been anticipated, either because of a change in desire or a decline in purchasing power or both.

5–3. Risk and Uncertainty. The word "risk" should be reserved for an insurable hazard and the term "uncertainty" used to express a noninsurable hazard. As we shall see later in this chapter, an insurable risk is both common and calculable. It can be provided for by periodic payments in the form of insurance premiums, which become costs of production and component elements in price. The greater the risk, the larger is the premium; the higher the costs of production, the higher is the price of the product in a competitive market in which prices approximate costs.

On the other hand, many uncertainties of business, both manufacturing and marketing, cannot be covered by insurance; they can be provided for only roughly or partially out of reserves compiled from the profits of good years. Their influence on prices of products is neither direct, proportionate, nor immediate. Many uncertainties of business, due to change in methods or loss of markets, cannot be included under costs of production and compounded in prices of products; they are residual. These uncertainties constitute losses if costs are above price of product. Price changes are common but not calculable; hence they are not insurable. Profits are price determined, rather than price determining; they are noninsurable uncertainties of business.

5–4. Depreciation and Obsolescence. Machines wear out at fairly definite rates; they must frequently be repaired and ultimately replaced. Hence, depreciation is a calculable cost of production that should be provided for on the books and included in the price of the product. Depreciation is a certainty and not an insurable risk, even though it is calculable.

Good machines can be rendered useless by an important invention, a marked improvement in process, or a great change in demand. This is known as obsolescence, or going out, in contrast to depreciation, or wearing out. Obsolescence is common but not calculable; it is an uncertainty of business, but not an insurable risk. If not adequately covered by a reserve fund, sudden and serious obsolescence must come out of current profits.

5–5. Failures of Business Enterprises. The spirit of gain lures men to take chances in the great lottery of business; it draws venture capital into new industries. The enterpriser is the central figure in an economic order characterized by uncertainty. He is the individual who assumes the

responsibility and the chief hazard of his particular undertaking. He pays wages to his employees and interest on borrowed capital. His profits are residual, *i.e.*, the enterpriser gets what is left. The margin of price over costs may be considerable for a while, but it is uncertain and can easily and quickly be reversed into losses. In the long run, losses tend to balance profits and to keep competitive prices down to costs of production.

The enterpriser, like the consumer, is the source of many uncertainties in modern economic life. Human beings have serious frailties to which enterprisers frequently succumb. Hence, there are individual causes of business failure, apart from those resident in our physical and social environments, although the individual himself is, in large part, the result of his environment.

According to Dun & Bradstreet, the preponderating majority of business failures is due to the faults of those failing. The list of causes given is suggestive but far from complete. It includes incompetence (irrespective of other causes), inexperience (without other incompetence), lack of capital, unwise credits, speculation (outside regular business), neglect of business (due to bad habits), personal extravagance, and fraudulent disposition of property. Failures not due to the faults of those failing include specified conditions (disasters, wars, floods, etc.), failure of others (apparently solvent debtors), and competition.

Wherever the fault may lie, the annual number of business failures in the United States runs into the thousands. Although fluctuating from year to year, an average mortality rate of 1 per cent of all business firms has been common, even through normal years.

5–6. Incidence of Financial Hazards. The enterpriser does not assume all the hazards of business. Much capital is borrowed, in addition to that contributed by those enterprisers who own their businesses. Bondholders and bankers, therefore, participate in the uncertainties of industry, although enterprisers stand as buffers between them and potential losses.

The worker, as well as the capitalist, is in danger. On labor's shoulders fall some of the heaviest burdens of modern industry, such as industrial accidents, dangerous trades, and unemployment. The hazards of workers are physical and human, for they risk life and limb. Those of enterprisers are pecuniary or financial, because they supply venture capital, out of which they make advances to workers while production is in process.

There are four possible ways of meeting the hazards of industry:

1. Reducing hazards through increased and improved control.
2. Diffusing risks through the group by insurance.
3. Shifting uncertainties to professional speculators by hedging.
4. Assuming residual hazards by the enterprisers themselves.

5–7. Reduction of Hazards. Although many dangers of industry can never be eliminated, they can be reduced. Our annual fire losses in re-

cent years have been averaging about 500 million dollars. Hence, fire marshals and insurance companies have striven to educate the people of the United States in fire prevention.

Science is striving to keep the genii of nature, which it has enslaved, from striking back at society. Power machinery, steam boilers, electric appliances, giant cranes, and elevators must be guarded and inspected. Each new invention requires additional precautionary measures. Railroads, for example, have made remarkable progress toward increased safety and comfort, despite greater speed and enlarged volume of traffic.

Marketing uncertainties center about price fluctuations. Just as greater knowledge of the physical sciences has reduced technological risks of industry, so business forecasting is seeking to reduce marketing uncertainties through studies of price movements, business cycles, and other economic data. Advertising has been utilized to secure a steadier and wider demand for certain products than would otherwise have been true.

5-8. Agencies Promoting Safety and Diffusing Information. Agencies reducing risks must be distinguished from those bearing risks, although many organizations perform both functions. For example, insurance companies not only pay fire or death benefits, but also educate people in fire prevention and health preservation. Workmen's compensation laws, likewise, not only provide for the victims of industrial accidents but also stimulate the "safety first" movement in industry.

Institutions for increasing and disseminating knowledge are agencies for reducing risks. They may be grouped as public or private; they may be general or limited in scope.

Various departments of our local, state, and national governments protect the lives and property of their citizens. Illustrations are departments of public safety, departments of agriculture, and weather bureaus. Departments of public safety enforce municipal ordinances which lessen fire and traffic hazards. Factory and building inspection is becoming more effective in preventing or reducing dangers. Both Federal and state departments of agriculture seek to eliminate animal pests and plant blights causing losses to farmers; continuous warfare, for example, is being waged against the cotton boll weevil and the Japanese beetle. The United States Weather Bureau has reduced losses by issuing storm signals to mariners and frost warnings to farmers.

University departments, endowed societies, and private organizations are cooperating with government bureaus in similar efforts to reduce the risks of industry through research work into the causes and control of waste. Modern business is slowly learning that ignorance, carelessness, guesswork, and rule of thumb are expensive. Knowledge is economy as well as power; it makes for both conservation and efficiency; it promotes safety as well as speed.

5–9. Business Forecasting. Statistical studies of current conditions permit forecasting future prospects. Although their accuracy is no greater than the forecasts of the Weather Bureau, perfect timing and absolute prediction cannot be expected; a reasonably high degree of probability is sufficient help in making business decisions.

Analyses of prices of commodities and securities can be correlated with statistics of bank clearings and loans, interest rates, freight-car loadings, and sales of merchandise by department stores and mail-order houses. By combining such economic items in the same way that the weather man puts together meteorological data of temperature, atmospheric pressure, and direction of the wind, general business tendencies can be observed, and specific danger threats can be discerned.

Engrossed with his own specialized work, the individual enterpriser is rarely able or willing to make such comprehensive forecasts. Nevertheless, it is essential that he be informed of general price movements and such other economic tendencies as are apparent. Such knowledge will permit the business navigator to set his helm. It will not eliminate financial shipwrecks, but it will chart with lighthouses and buoys the rocks of inflation and expansion, or the shoals of deflation and depression. Our business navigator, no matter what his cargo, will do well to know his position in the currents of the ever-recurrent business cycle.

5–10. Essentials of Insurable Risks. An insurable risk is one that is both calculable and common. Losses due to fire and flood are insurable risks for these two reasons. The long series of weather records make it possible to estimate the mathematical chances of rain on a specified date and in a particular locality. Hence, rain insurance is possible.

Although price changes are as common as weather changes, they are not so calculable in terms of mathematical probability. Because they cannot be put on an actuarial basis, losses due to price changes must still be viewed as noninsurable uncertainties instead of insurable risks. The enterpriser must seek protection here by hedging through speculative contracts.

Keeping vital statistics has made possible the compilation of actuarial tables of life-expectancy rates, and, thereby, the development of life insurance. It is not possible to say in advance that a particular individual will die on some specified date. Nevertheless, it is possible to state that a certain percentage of normal men and women, now apparently hale and hearty at twenty-one years of age, will die before reaching forty. Similarly, we can estimate with mathematical exactness the probabilities of their living to be fifty, sixty, or seventy years of age. Some individuals will live longer than this mathematical estimate, but others will not live so long. Hence, insurance depends on the law of averages and the insurance of a large number of individuals. A given risk can be calculated

with mathematical accuracy, but it cannot be regarded as an insurable risk unless it is common enough to permit the insurance of a large number of cases. In this way underestimates tend to balance overestimates.

5-11. Principle of Reserves. A final feature of an insurable risk is that a relatively small reserve is sufficient protection against large possible losses. If all the houses of a certain section of a city were to take fire, the amount of fire hose and other such apparatus in the vicinity would be inadequate. If all the insured clients of a large insurance company were to die about the same time, the greatest financial reserves would be inadequate. But fire statistics and mortality tables show that such possibilities are rare in the actual experiences of life.

Scientific insurance, like sound banking, is built on the principle of adequate liquid reserves. If all depositors should demand all their deposits at precisely the same time, banks could not meet this huge, sudden demand for cash, because most of their funds are frozen in sound investments or loans to customers. Even solvent banks cannot be 100 per cent liquid or they would not be able to make money. A run on a sound bank would be fatal if other banks failed to respond by lending their surplus cash. An experienced banker can estimate what proportion of total deposits must be kept constantly available as cash. State banks and national banks are governed by different regulations concerning these reserves in cash or deposits in other banks.

Insurance companies likewise are not forced to maintain sufficient cash funds to pay full claims to all insured at all times, for all houses will not burn down simultaneously. All men must die, but they do not do so at the same time. Receipts of premiums from insured individuals are sufficient to meet ordinary claims and running expenses. But legal-reserve insurance companies have additional funds in banks and huge investment portfolios of income-earning securities, which can be drawn against in case of such emergencies as epidemics or great fires.

5-12. Nature and Kinds of Insurance. Insurance may be defined as the substitution of a small, certain, and regularly recurring loss, called a premium, for a large and uncertain loss, which may never occur or recur to an insured individual. Insurance then is the diffusion of a particular risk among the large and homogeneous group subject to it. Those individuals who do not experience the hazard against which they are insured or who experience it at a later date or in a subaverage form help to pay for the greater losses of other less fortunate insured individuals who do suffer. All members of the group receive protection, but only those who suffer losses receive compensation from the pooled resources.

Insurance may be grouped into three general classes: personal insurance, property insurance, and social insurance. Life insurance is the most common type of personal insurance, and fire insurance is the most com-

mon type of property insurance. Both will be treated in this chapter. A discussion of social insurance will be deferred to a later chapter.

Most life-insurance companies now are mutual, *i.e.*, "profits" or excess premiums above costs of operation, payment of benefits, and creation of reserves are prorated and returned to the policyholders as dividends. These dividends can be subtracted from premiums to be paid or they can remain with the company to increase the face value of the policy.

Most fire insurance is written by stock companies operated for profit and paying dividends to their stock owners instead of their policyholders. Whether life or fire, mutual or stock, the very nature of insurance is as cooperative as it is compensatory.

5–13. Personal Insurance. *a. Life Insurance.* Life insurance is the most important kind of personal insurance. Unless his policy is of the endowment type or possesses annuity features, the insured individual receives no direct benefit from his insurance other than his own peace of mind. Life insurance is generally purchased by the head of the house to keep the wolf from the door of his potential widow and orphans. Although money cannot lessen the bereavement, the payment of death claims can compensate, at least in part, for the loss of earning power of the breadwinner. The insured individual can project into the future his plans for the family. Indeed, life insurance is the only method by which an individual can create immediately an estate equal to the face value of his policy by the payment of a single premium.

Corporations may insure the lives of responsible heads of their businesses. They thus seek to capitalize the value of an individual's services and to compensate themselves in the event of loss of his industrial leadership. Partners similarly may insure their lives in favor of each other or the partnership. Creditors may insist that debtors insure their lives to the amount of the loan.

The issuance of an individual life-insurance policy is generally conditioned by the applicant's passing a satisfactory physical examination. Such an examination may be omitted in the issuance of group insurance, by which a large number of individuals (for illustration, the employees of a certain firm) are simultaneously insured.

Premiums of life insurance, *i.e.*, its annual costs, depend on the face value of the policy and on the age of the person when he secures insurance; the younger the individual, the lower the rate. The premium varies also according to the number and character of supplementary benefits which may be written into a life-insurance policy in addition to the payment of death benefits. For example, there may be double indemnity for accidental death or waiver of premiums in the event of disability.

There is the possibility of paying the premiums, not until death terminates the contract, but only for a specified number of years, as in the twenty-

payment plan, or all at once, as in the single-payment plan. In such cases, premiums are proportionately higher than in ordinary life insurance; the fewer the payments, the higher the rate.

Life-insurance policies fall into two groups: straight life insurance, and endowment policies. The former is cheaper to purchase, for it pays only the stipulated sum at death. Endowment policies are more expensive; the premiums give not only protection but also investment. An endowment policy matures at an advanced age or on the payment of a specified number of premiums, after which its holder ceases to pay further charges. He may continue his policy in force without additional cost, or he may elect to receive its cash surrender value, or he may convert it into an annuity.

b. Annuities. An annuity is a form of protection that involves the same actuarial tables and investment calculations as are used in the determination of life-insurance rates. But life expectancy is viewed from the opposite point of view, for the death of an annuitant is a financial relief instead of a burden to the insurance company. An annuity can be purchased by the payment of a lump sum, immediately after which, or at a later specified date, the beneficiary receives regular payments at stipulated intervals as long as he lives. The cost of an annuity varies directly with the size of the benefits and inversely with the age at which it becomes operative. Annuities may be bought also by the payment of regular premiums in the early years of life. It is possible to incorporate annuity features in a life-insurance policy that pays both death benefits and survival annuities.

c. Accident, Illness, and Disability. There is no guarantee against accidents, but there is insurance in the form of financial compensation in the event of an accident. Policies may provide funds merely for surgical, medical, and nursing care at home or in a hospital. They may also provide cash compensation for loss of earning power during illness and convalescence. Finally, their benefits may include a lump sum for accidental death or periodic payments for partial or total, temporary or permanent disability due to an accident.

Sickness and disability insurance is like that against accidents. Rates vary similarly according to degree of protection and extent of benefits. Because sickness is as common as its cause is dubious, and because malingering may be pleasant and profitable, comparable rates for sickness insurance are necessarily higher than those for accident insurance. So are rates for disability, which may be long and which always is serious. Disability may be temporary or permanent; it may be partial or total. Its insurance rates, consequently, vary greatly according to type of policy and according to time or degree of disability covered by it.

Because of the great necessity and the high cost of these types of protection, they have been included in most programs of social insurance

provided by many foreign governments. But in the United States there has been strong opposition to public health insurance and cash compensation for accident, illness, or disability except that arising from industrial causes. Such compensation has been paid in modest amounts on a voluntary basis by progressive firms, enlightened unions, and private insurance companies.

Many American cities have organized Associated Hospital Service, popularized as the Blue Cross, under which individuals employed in large groups may purchase at modest cost for themselves and their families insurance policies covering hospital costs, in part at least, in the event of serious accident or illness. Attempts to extend this form of insurance to cover medical and surgical fees have been opposed. Most of these plans still do not provide cash compensation to cover loss of earnings due to accident, illness, or disability.

5–14. Property Insurance. *a. Fire Insurance.* Fire insurance is one of the most important types of property insurance. Both buildings and the furniture in them can be insured against damage or destruction by fire and its consequent losses. Precautionary measures and improved fire-fighting apparatus reduce the danger of conflagration and therefore lower the premiums of fire insurance.

b. Miscellaneous Types. There are many other types of property insurance, such as plate-glass-window insurance, tornado or hail insurance, burglary insurance, etc. Marine insurance is designed to cover losses at sea. Casualty insurance, a broad term, refers to coverage against various kinds of accidents or specific mishaps. Automobile insurance includes several types of casualty insurance, such as fire, theft, liability, and collision. Collision insurance compensates for injuries to one's own automobile or self, and liability insurance covers possible damage to other individuals and their property. The greater the risk, the higher is the rate; a good safety record may reduce the premium on automobile insurance.

5–15. Assessment Plan versus Legal-reserve Insurance. The assessment plan was formerly common among fraternal societies. With the death, disability, sickness, or unemployment of a member of the society, all other members contributed a specific sum, generally stipulated in advance. The assessment plan illustrates the mutual character of insurance and its diffusion of risks throughout the group. But in spite of its benevolent purpose and beneficial features, the assessment plan lacks security and stability. Mutual-benefit societies prospered for a while, but they came to grief as assessments increased and young members failed to replace the ranks of older beneficiaries.

"Old-line," or legal-reserve, insurance implies the basing of premiums on ascertainable degrees of risk, the securing of a sufficient number of insured individuals, and, finally, the accumulation of adequate financial

reserves. Insurance by assessment often lacked all three of these requirements of sound insurance.

5–16. Carrying One's Own Insurance. If a business is large enough, it can carry some of its own insurance. Let it be assumed, for illustration, that a certain business corporation owns many buildings, widely separated from each other. Statistics as to the frequency and severity of fires make it possible to estimate the fire hazard. Consequently, that corporation may put aside specified funds each year for its own fire insurance. It may invest these reserves in sound securities; or it may keep them in its own business, in which case there is a mere record on the company's own books. In either event, however, these yearly payments are regarded as an annual cost of doing business, similar to insurance premiums. From the accumulated reserve, the company can reimburse itself or readjust its books in the event of fire.

A frequent danger in carrying one's own insurance is the failure to estimate adequately a given hazard, to build up sufficient reserves against it, and to keep them in liquid form outside one's own business. Again, there is only a limited opportunity to diffuse the hazard over a sufficiently large number of business units.

5–17. Reinsuring and Pooling Insurance. Insurance companies like to limit and to scatter their risks. No one fire-insurance company, for example, will insure many adjoining houses. If a very large life-insurance policy is desired, several life-insurance companies may syndicate or unite to underwrite that risk; *i.e.*, they divide the total amount of insurance among themselves in a mutually agreeable manner. One company may have some of its risks reinsured by another company or collectively and cooperatively by several companies. Finally, there is coinsurance, under which plan the insured person shares losses with the insuring company; this practice is common in fire insurance, where it keeps down rates and risks.

5–18. Guaranty and Suretyship. These forms of protection are often spoken of as insurance, although they are not insurance in the strict sense of that term. Trust companies, for example, will guarantee the validity of real-estate titles, and surety companies will reimburse their bondholders against losses suffered because of the dishonesty of bonded employees.

The guaranty company does not charge an insurance premium based on the hazard of a particular real-estate title. It examines or merely confirms a prior examination of the legal records to make sure that a clear title to that piece of real estate exists. If so, the guaranty company issues what is known as title insurance. The policy agrees to indemnify its holder and the owner of that real estate against any subsequent and successful claim arising from a defect in its title.

A surety company or bonding house does not try to calculate the individual chances of prospective employees defrauding their employers and then express these hazards in a varying scale of premiums based on their relative dishonesty. General hazards only are estimated. An investigation is made of the character of each individual before he is guaranteed. If there is doubt of his honesty, the company does not issue the bond. In the event of defalcation by a dishonest employee who has been bonded, that surety company makes good the loss up to the amount of the bond and then attempts to recover from the individual who has defalcated.

5–19. Protection against Uncertainties. There are some hazards of industry for which the enterpriser cannot obtain insurance. Chief among these are the dangers of losses from cancellation of orders, or from a cut in price. The anticipated profits from the manufacture of a particular article may be eliminated by a drop in orders or by a decline in price. On the other hand, the estimated profit may be increased by unexpected orders or by a rise in selling price.

The enterpriser may seek relief from possible shrinkage of his market by decisions to manufacture only on order and not for stock. Such action would reduce his uncertainties, but it would limit his sales.

The enterpriser usually must manufacture in anticipation of demand, even though he does not care to speculate on price changes. He prefers to know definitely the cost of his raw materials and the price of his finished product. Just as he generally insures himself against loss by fire or theft, so he may seek to protect himself also against losses from price changes. He does this by making contingent or advance contracts; he may also resort to a device known as "hedging."

5–20. Contingent or Provisional Contracts. A contingent or provisional contract is a common method of protection against both uncertainty of demand and fluctuation in price. Let it be assumed that the enterpriser is a builder who is estimating on the price of a proposed home. He prepares a list of materials needed from the specifications of the architect who has drawn plans for this house. Before submitting his bid, the builder places provisional contracts with lumber, brick, and stone dealers to supply him with these requisite materials. If he is not planning to do all the work himself, our builder makes similar contingent contracts with various subcontractors to whom he proposes to turn over such specific jobs as masonry, carpentry, plumbing, steam-fitting, electric wiring, and bricklaying. If his bid on the house is accepted, these provisional contracts become final for the purchase of those commodities or services at their contracted prices. Thus, the builder or contractor is able to estimate with some degree of accuracy his total costs of building the house according to the specifications of the architect. If his bid is accepted, the builder is

guaranteed not only a market for his house at a specified price, but also definite costs for his work and material.

5–21. Advance Contracts through Dealers in Futures. An advance contract permits a businessman to buy, or binds him to sell, at a specified future time a specific amount of a particular commodity at a price agreed on in the present. Many staples, such as cotton and wheat, as explained in the previous chapter, are sold not only for immediate delivery but also for future delivery at a currently quoted price. The miller of flour or the manufacturer of textiles can thereby assure himself of an adequate future supply of wheat or cotton at a definite cost, on the basis of which he can, in turn, quote prices for his product with the expectation of a fair margin of profit.

Wheat and cotton futures are traded continuously on produce exchanges. Functional middlemen, as we have seen, are professional speculators in these staples; they are always willing to buy futures at a price that seems low enough to indicate a profit on a later sale and to sell futures at a price that seems high enough to make a corresponding speculative profit on a later covering purchase.

Flour millers or textile manufacturers are willing to shift this uncertainty of price change with its possible additional profit or its potential loss to those professional dealers in futures, even though they may thereby pay somewhat more for their wheat or cotton than they might have to pay for these same commodities were they to buy them as needed later on spot markets. This slight, potential increase in the cost of raw materials, bought in advance for future delivery, is the cost of security. Although not insurance, it is comparable to it. The manufacturer thereby obtains price protection; the middleman seeks speculative profits by price changes and uncertainties.

5–22. Hedging. Hedging is another device that permits a manufacturer or processor to protect himself against the noninsurable uncertainty of price changes. He does so by making speculative contracts in the opposite direction but in an equivalent amount to his own business deal. The manufacturer obtains price protection by a pair or series of pairs of simultaneous buying and selling transactions, one in his own business and the other in a broker's office. Through a perfect hedge, a loss or gain in one transaction is exactly offset by a compensating gain or loss in the other. Hedging has been compared to betting against one's own team. To win in one way is to lose in another manner.

An illustration may help to clarify this complex device of hedging. A flour miller buys a considerable quantity of grain at present prices for actual delivery and storage in his warehouse, in order to be ready for anticipated business. If the price of wheat should rise within the next few months, this miller will make an additional and unforeseen profit

from his previous purchase of cheap grain in the spot market. If, on the contrary, the price of wheat should fall, his loss would be correspondingly great from the same purchase. Although orders for flour might not decline, the selling price of this flour would be lowered in adjustment to the decline in the price of wheat, its raw material. Such a decline in the price of flour would reduce and might eliminate the anticipated normal milling profit; it might even substitute a net loss for a fair manufacturing profit.

If it were possible for a miller to grind wheat on a commission basis without taking title to it, or if he could buy wheat economically and frequently in small quantities as he disposed of an equivalent amount of flour, he would not be concerned with the problem of price changes and with the necessity of hedging. But such is not the case. Milling is rarely done on order; the miller ordinarily buys wheat in carload lots to keep down the cost of his raw materials and freight rates; he must sell flour by the barrel to his customers when they demand it.

The miller desires to have on hand a sufficient supply of grain to fill all orders within the immediate future, but he does not wish to be caught with expensive wheat in a falling market. He therefore resorts to hedging, a device by which an unavoidable uncertainty in one's own business is negated by an equivalent speculation in the opposite direction. It is like fighting fire with fire.

At the same time that our miller places an order for the immediate purchase and actual possession of wheat from a grain elevator, he also makes a speculative contract with a broker to sell title to an equal amount of wheat futures. If the spot price of wheat bought is exactly the same as the price of wheat futures that he is committed to sell, the hedge is perfect. Such a condition is rare, and the differential is a cost of security.

If the price of wheat should fall, this miller will make on his speculative or selling-short contract when he covers it by a subsequent purchase; but he will lose an equivalent amount from the expected manufacturing profit on the sale of his flour. If, however, the opposite situation should come to pass, and the price of wheat should rise, our miller would obtain a higher price for his flour than he had expected, but he would take a corresponding loss when he covered his speculative short sale.

In other words, hedging offsets an additional business profit or an unexpected loss from price changes by a compensating and corresponding loss or profit from speculation. It shifts this noninsurable uncertainty to brokers or functional middlemen. These professional speculators will always accept the hazard of price changes in commodities or find others who will do so.

The safety of this group of professional speculators lies in the fact that they make many such commitments on both sides of the market. Their gross losses offset their gross gains. Their net profit, like that of a gam-

bling house taking all standardized bets, lies in their deliberate loading of chances. These professional operators speculate both ways, but only if they can secure a sufficient number of offsetting cases, which are fairly evenly distributed, and which are obtained at slightly favorable odds each way.

5-23. Insurance Compared with Gambling, Speculating, and Investing. Insurance is said to have developed from the bet of a shipowner that his vessel would not cross the seas safely and return with its cargo intact. If it did, the owner was able and willing to pay the bet; but if it did not, he was compensated for its loss by the amount of the wager. Although the form of insurance has changed with the passage of years, it may appear to some individuals that insurance is still a bet placed under standardized conditions. The existence of calculable risks merely makes easier and fairer an estimate of the mathematical chances of such a wager.

This confusion between insuring and gambling ignores the important difference that in a gamble one individual's gain is another's loss, whereas insurance represents mutual benefit. Insured individuals may never be forced by circumstances to collect insurance benefits, but they have received protection in the meantime. Gamblers, however, win or lose something for nothing. Hence, insurance is socially desirable, whereas gambling is not.

Insurance requires the existence of calculable risks and of sufficient cases to permit the law of averages to operate. Gambling may involve these two elements, but they are often absent. There are some so-called "insurance firms," however, which will issue policies against uncertainties which are neither calculable nor common. But such "insurance" is misnamed when these essentials of an insurable risk are absent. The process often savors more of gambling than of insuring, although it does permit legitimate enterprisers to protect themselves against certain inherent hazards of their businesses.

Speculation, as shown in the last chapter, consists of buying or selling in the present market with a view to profiting by the reverse operation in the future. The aim of speculation is gain, whereas the purpose of insurance is protection. Moreover, the uncertainties of speculation, *i.e.*, price changes, are not insurable risks. Hedging is analogous to insurance in that it permits a businessman to protect himself by speculative contracts against the noninsurable hazard of price changes. But hedging shifts the uncertainties of price changes to a limited group of professional speculators, whereas insurance diffuses the risk throughout the entire group of insured individuals. On the whole, speculation is subject to greater abuse than is insurance. Individuals cannot insure themselves against risks which they do not face, but they can and do speculate in the prices of produce, securities, and land outside their regular business and

without the legitimate reason for speculation confronting the miller who resorts to it in order to hedge.

Investment represents the purchase of income; but insurance, the purchase of protection. Both insurance and investment involve saving and thrift. Life-insurance premiums, like savings-fund deposits, are paid out of present income. Many insurance policies combine the elements of investment and protection. Illustrations are endowment policies providing for the payment of a flat sum or an annuity after a certain age.

An insurance company acts as middleman between insured individuals and industry in the same way that a bank acts as middleman between its depositors and industry. Assets of a commercial bank include short-term loans to businessmen in the form of commercial paper. Assets of an insurance company, like those of a savings bank, include long-term loans in the form of bonds and mortgages.

Sound insurance necessitates investment, because it involves the creation and maintenance of reserves. Life-insurance companies alone invest millions of dollars each week. Total life insurance in force in 1947 was approximately 175 billion dollars.

5–24. Gambling, Speculating, and Investing Compared. The universality of risk and uncertainty in industry gives rise to the common statement that "all business is a gamble." It is necessary, however, to distinguish between gambling and speculating and between speculating and investing. Although there are twilight zones where classification is difficult, it is possible to indicate certain general distinctions.

A gambler creates or invites his hazard, but a legitimate speculator finds the element of uncertainty inherent in his own business. The chief distinction between gambling and speculating lies in the economic necessity for the element of chance and in the social desirability of such an assumption of uncertainty. Gambling does not imply cheating, and the honor code of its devotees may be high. It is also true that gambling may involve definite probabilities, which can be computed with mathematical accuracy. Nevertheless, gambling is economically unproductive and socially undesirable, because it represents the taking of money without some compensating service. Gambling is based on luck or skill or both, but speculation is based on belief; it should involve some rationalization of one's views on future price trends or one's need for price protection. The speculator should have accurate and abundant information; the amateur gambler often has only inclination. The speculation of professional dealers in futures is based on business experience and available data; their activities stabilize market prices and permit businessmen to hedge.

The distinction between speculation and investment is as difficult to make as that between speculating and gambling. These concepts grad-

ually fade into each other like the colors of the spectrum. While gambling is based on chance, and speculation on belief, investment is based primarily on knowledge. Speculation flirts with possible or anticipated values, but investment deals with actual or present values. Both the financial hazard and the rate of return are relatively lower in investments than in speculation. Indeed, the possible rate of return or potential appreciation in speculation is usually in proportion to the uncertainty involved.

Other differences lie in purpose and time. An investment is made to provide future income, and the investor expects to keep his purchase. A speculation is made in anticipation of a future sale or purchase and with hopes of an early profit from the transaction. Wall Street draws its own sharp line between investment and speculation. Brokers are inclined to use the term investment when the purchaser pays in full and takes immediate possession of his security. The transaction is called speculation when one buys on margin or sells short, and where it is apparent that temporary gain, rather than permanent security of income, is desired.

A similar situation exists in the real-estate market. An investor purchases a piece of land or a building with the expectation of using it himself or living on the rent. A speculator buys with the hope of a profitable resale in the near future. Although often difficult to distinguish, the case is clear when a speculator does not take title to his real estate but merely buys an option or the right to purchase later at a specified price. Such an option is generally negotiable; it can be sold and resold to other speculators like stock bought on margin. The case is not so clear when real estate is bought subject to a mortgage, a situation that also is comparable to buying stock on margin even though it is less speculative in character than the purchase of an option, because the buyer does take title and he may occupy the building.

Guide Questions on Text

1. Outline sources and types of business hazards.
2. *a.* Distinguish between risk and uncertainty.
   b. Relate to costs and prices.
3. Differentiate between depreciation and obsolescence.
4. *a.* In what different ways can the hazards of business be met?
   b. Define each and differentiate among them.
5. How can business hazards be reduced?
6. What are the essentials of insurable risks?
7. *a.* What are the nature and significance of reserves?
   b. Is there a principle of reserves? If so, what?
8. *a.* What are guaranty and suretyship?
   b. Why are they not insurance?
9. Contrast speculation with insurance.
10. Compare speculation with investment.
11. Why are price changes and profits not insurable risks?
12. Explain each and distinguish between contingent contracts and advance contracts.

13. State nature and purpose of hedging. Explain mechanism.
14. Distinguish gambling from speculating if possible.
15. Contrast gambling with insuring.
16. *a*. Outline different types of insurance.
    b. What are some elements common to all of them?
    c. What are some features peculiar to each of them?

Topics for Investigation

1. Progress and increased hazards of life.
2. Science and the reduction of risks.
3. Credit insurance or business failures as insurable risks.
4. Legal-reserve insurance compared with assessment plans.
5. Growth in volume and kinds of insurance.
6. Investment of insurance reserves.
7. Carrying one's own insurance.
8. Industrial policies of life-insurance companies.
9. Group-insurance programs.
10. Contingent and advance contracts.
11. Dealings in futures on commodity exchanges.
12. Hedging operations of flour millers or other businessmen.

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Part Three

PROBLEMS OF DOMESTIC EXCHANGE

CHAPTER VI

MONETARY PROBLEMS

6–1. Nature and Functions of Money. An analysis of monetary problems necessitates a clear understanding of the nature and characteristics of money. So many popular misconceptions exist as to the significance of money in modern society that it is impossible to discuss monetary problems intelligently without first removing some of these persistent errors. The fact that money will buy things has led to the common belief that human welfare and happiness depend on having plenty of money. Indeed, a certain moral significance is popularly attached to its possession. A person is said to be worth so many million dollars because he happens to have control over funds to that extent. Business success, material progress, good fortune, "worth," all these are measured alike by most persons in monetary terms. Because of the pecuniary character of modern economic life, it is essential at the outset that the nature and characteristics of money be understood.

Money is a convenient tool, a device that man has developed to facilitate the exchange of economic goods. It is a go-between, a medium of exchange, which makes possible both disposing of and obtaining economic goods to gratify human desires. If there were no economic goods over which to obtain control, there would be no meaning to medium of exchange, or money. A person stranded on a desolate island with heaps of "money" in his possession would soon discover that all this meant nothing if it could not buy him food to keep from starving. Therefore, it should be kept clearly in mind that it is not the possession of money but the economic goods the money can buy that ultimately determines the extent to which human desires can be gratified with the aid of these goods.

Money does not serve merely as a convenient medium of exchange. It is also the standard or measure of value, in terms of which the values of all other economic goods can be expressed. When the value of an economic good is thus expressed in terms of money, this value is called "price." Price, therefore, is value expressed in terms of money.

In modern industrial society, money performs another very important function that is really a corollary of its function as a standard of value. It is used as a standard of deferred payments since it has become custom-

ary to express credit transactions in monetary terms. The debtor and creditor relationship, which has been so extensively developed in modern industrial society, emphasizes the significance of this third function of money and stresses the importance of seeking to devise a stable standard of deferred payment.

Finally, money serves as a store of value. Among primitive people, actual metallic currency, such as gold, is extensively hoarded. People in advanced countries also save and hoard money for use at a later date. The money thus saved represents claims to wealth that are not currently redeemed. If invested, these claims are activated, as they are ordinarily used to buy actual wealth by the borrower. But if held as idle or hoarded cash, as will be shown later, the holding of extensive claims to wealth in liquid but sterile form may become a major cause of a business depression. The behavior of individuals in the use of their store of value in monetary form exerts a profound influence upon the functioning of our economy.

In summary, money performs four functions in our economy. It serves (1) as the generally accepted medium of exchange, (2) as the standard of value, (3) as the standard of deferred payments, and (4) as a store of value. Monetary problems arise wherever money fails to perform any or all of these functions satisfactorily.

6–2. Types of Money. There are many kinds of money that may serve as circulating media. They may be classified as follows:

a. Primary or commodity money, such as gold coin, the commodity value of which is the same as the value of the money into which this commodity is convertible.

b. Token money, such as silver dollars and subsidiary coins, *i.e.*, half dollars, quarters, dimes, nickels, and pennies, the metal value of which as bullion is considerably less than the face value of these coins.

c. Representative money, comprising warehouse receipts for metallic money, such as gold certificates and silver certificates.

d. Credit money, which represents the promise of the government to pay. When this promise is redeemable in primary money, such as gold on demand, the credit money is said to be convertible. If it is not redeemable on demand, it is inconvertible. It becomes fiat money when made full legal tender by the governmental proclamation, even though it is not secured by an actual item of wealth. By full legal tender is meant that currency designated by law which must be accepted at its face value in payment of all debts, except those specifically exempt.

6–3. Kinds of Money in the United States. According to the monthly statements of the Treasury Department, the different kinds and amounts of money in the United States on Sept. 30, 1939, at the beginning of the Second World War, and on Dec. 31, 1945, shortly after the close of the war, are shown in Table 1.

TABLE 1. KINDS AND QUANTITIES OF MONEY IN THE UNITED STATES

Kinds of money	Stocks of money in United States	
	Sept. 30, 1939	Dec. 31, 1945
Gold	$16,931,521,384	$20,064,936,333
Gold certificates	(14,749,722,596) *	(17,914,092,337) *
Standard silver dollars	547,078,589	493,942,783
Silver bullion (Act of May 12, 1933)	1,266,658,254	1,703,891,228
Silver certificates	(1,724,307,267) *	(2,051,475,832) *
Treasury notes of 1890	(1,165,772) *	(1,149,458) *
Subsidiary silver	386,476,648	856,932,648
Minor coins	164,030,984	317,386,695
United States notes	346,681,016	346,681,016
Federal reserve notes	4,989,003,950	25,633,379,605
Federal reserve bank notes	25,064,719	502,261,413
National bank notes	183,054,557	118,380,650
Total	$24,839,570,101	$50,037,792,371

* These amounts are not included in the total, since gold or silver held as security against certificates and treasury notes of 1890 is included under gold, standard silver dollars, and silver bullion, respectively.

Currency in actual circulation outside banks was 26.6 billion dollars in November, 1947, as compared with 26.5 billion dollars on Dec. 31, 1945, or about the same amount.

The per capita monetary circulation in the United States on Sept. 30, 1939, was $55.50. This represented the portion of the stock of money not held in the Treasury of the United States nor as reserves either by Federal reserve banks or Federal reserve agents. Per capita circulation on Dec. 31, 1945, was $203.29, or almost four times that at the outbreak of the Second World War. This sudden and great increase in the quantity of money was an implied threat of price inflation. But the so-called "circulation" figures are somewhat misleading. Although they indicate money of one kind or another in possession of people, some of these funds may be hoarded and neither spent for current consumption nor invested. In spite of the larger "circulation" figures for December, 1945, as compared with September, 1939, the actual volume of spending had not increased correspondingly during the war period. Wartime price controls and rationing retarded the turnover or circulation of this large increase in available spendable funds. Some cash was spent in black-market operations, but an ever larger part of the expanded supply of money was being held as idle cash balances.

As will be seen subsequently, money of one type or another represents only a relatively small part of the actual medium of exchange in the

United States. Commercial bank credit in the form of deposit currency, sometimes also called "checkbook money," is normally the chief medium of exchange in our economy. Therefore even a substantial increase in actual monetary circulation in our peacetime economy would have a limited effect on economic activity, particularly if it were offset by a decrease in bank deposits or bank clearings representing payments by check.

The circulation of so many different types of money in the United States raises some pertinent questions. How did these monies come into existence? What functions do they perform in our exchange economy? Why do they all have the same buying power? The answers to these monetary questions will be given in the following pages.

A brief survey of the historical development of our monetary system will show how these various kinds of money came into being, and why present-day monetary requirements can be met satisfactorily with a simpler money mechanism.

6-4. Our Early Bimetallic Monetary System. In 1792, the Congress of the United States passed a coinage law adopting both gold and silver dollars as standards of value and full legal tender. Thus bimetallism was established early in this nation's history. The mint, or coinage, ratio, established between silver and gold by the Act of 1792, was 15 to 1. This meant that a silver dollar weighed fifteen times as much as a gold dollar. Gold and silver dollars circulated side by side for a period of time; they were freely interchangeable at the mint in the above ratio. Similarly, fifteen ounces of silver bullion of standard fineness could be obtained for one ounce of standard gold and vice versa.

Some time after 1792, however, the international market ratio between silver and gold became nearer 15½ to 1 than 15 to 1. In foreign markets a person could purchase approximately 15½ ounces of silver for 1 ounce of gold, but at home for 15 ounces of silver he could obtain 1 ounce of gold at the mint. He would thus profit to the extent of about one-half ounce of silver on such a transaction, not considering transportation costs. Under these conditions silver bullion was brought to the mint to be coined, and gold coins were converted into bullion to be used in the markets of the world, either to buy more silver or to make foreign payments for other goods. As more silver came into circulation, gold slowly disappeared, and a silver monometallic standard replaced the former bimetallic standard. Silver, overvalued at the mint, was driving the undervalued gold from circulation.

This tendency of a legally overvalued money to displace a legally undervalued money is commonly referred to as "Gresham's law." It is named after Sir Thomas Gresham, an adviser to Queen Elizabeth, who formulated the principle, although it had also been expressed by some earlier writers.

Realizing that silver was slowly displacing gold, Congress, in 1834, attempted to change the situation in order to bring gold back into monetary circulation. Under the Acts of 1834 and 1837 a new mint ratio was adopted, which was 15.988 to 1, or, as it is commonly spoken of, 16 to 1. According to this newly adopted ratio, the standard silver dollar was to contain 371.25 grains of pure silver and the standard gold dollar 23.22 grains of pure gold.

As a result of the adoption of this new coinage ratio, silver was now undervalued at the mint, for the international market ratio remained about 15½ to 1. At the mint, approximately 16 ounces of silver exchanged for 1 ounce of gold, but in world-wide markets for the precious metals, it required only 15½ ounces of silver to acquire 1 ounce of gold. Thus the gold was taken to the mint to buy the undervalued silver in order to profit from its sale abroad. Silver, in consequence, gradually disappeared from circulation, and gold became the single standard of value of the country. Thus our legally bimetallic monetary standard, in effect, was monometallic—at first silver and then gold. This situation continued until the Civil War.

6–5. Inconvertible Paper Standard. During the Civil War, under the Act of 1862, United States notes, popularly referred to as "greenbacks," were issued in excessive quantities by the Federal government, and made full legal tender. Four hundred and fifty million dollars of such legal-tender notes were issued in 1862 and 1863. This was more than the total quantity of money in circulation on June 30, 1860. Greenbacks were not convertible into gold prior to 1879, and so depreciated rapidly in terms of gold. Both gold money and fractional coins disappeared from circulation in accordance with the operation of Gresham's law. The United States had thus been brought to an inconvertible-paper standard. The greenbacks, put into circulation by the government, were a form of political or fiat money, since their acceptance as money grew out of their legal-tender qualities and did not depend on their convertibility into gold. In 1879, however, the United States resumed specie payment by making greenbacks convertible into gold on demand, and so ceased to be on an inconvertible-paper basis.

6–6. Limping Bimetallic Standard. In 1873, Congress omitted the standard silver dollar from the list of authorized coins and established the gold dollar as our sole unit of value. The Act of 1873 stated that 25.8 grains of gold nine-tenths fine, or 23.22 grains of pure gold, bearing the required stamp and impress of the government, was a dollar. The monometallic gold standard triumphed over bimetallism. But since silver was allowed to continue in circulation as full legal tender, although under restricted coinage, the monetary standard in the United States after 1873 has sometimes been called the "limping" standard.

In 1878, Congress required the Secretary of the Treasury to purchase monthly from 2 to 4 million dollars of silver bullion in the markets of the world and to coin it into silver dollars. Under the operation of the Act of 1878, about 300 million silver dollars were coined during the next 12 years. These silver dollars were largely deposited with the United States Treasury, and silver certificates, redeemable on demand, were issued therefor. Because the international market ratio of silver to gold, *i.e.*, the price of silver in terms of gold, continued to fall even after the purchase of large amounts of silver by the government, agitation for cheap silver money continued. It was particularly pronounced among the agrarian classes in the South and Middle West, for as will be shown in the following chapter, cheap money means higher prices, which benefits debtors by permitting them to pay creditors with cheap dollars.

The Sherman Act of 1890, aimed at further monetization of silver, required the Secretary of the Treasury to purchase 4.5 million ounces of silver monthly at the market price, to be paid for in Treasury notes. These notes were made full legal tender and were redeemable in either gold or silver coin. The silver thus purchased was to be coined into silver dollars as rapidly as the notes were presented for redemption. The Act of 1890 also provided that the notes, when redeemed, might be reissued.

As a result of the operation of the Acts of 1878 and 1890, the Federal government accumulated over 576 million silver dollars. Only a small number of them, however, were ever in actual circulation; most of them were kept in the Treasury. Silver certificates redeemable in silver on demand and the Treasury notes of 1890 secured by silver were circulated in their stead.

6–7. Gold Standard Act of 1900. In 1893, the Silver Purchase Act of 1890 was repealed because the increasing influx of silver coin was resulting in a proportionate withdrawal of gold from circulation. In 1900, Congress passed a law definitely making the gold dollar of 25.8 grains of gold nine-tenths fine the standard of value of the United States, although nominally the gold standard had been in existence since 1873.

Strictly speaking, however, silver dollars were continued as full legal tender, and so continued to "limp" along with the gold standard. But for all practical purposes the United States was on a gold standard, so long as all forms of money issued or coined by the government were kept on a parity with gold by being redeemable in gold on demand. This situation continued until 1933.

The law of 1900 also provided for the redemption of greenbacks in gold on demand. It required that a reserve of 150 million dollars in gold be created for this purpose by selling bonds. The greenbacks thus redeemed could be reissued, but only in return for gold. Because of the danger of reduction in the weight of gold coins in circulation due to abrasion, as

well as possible loss of such coins by their owners, Congress, as early as 1863, had authorized the issue of gold certificates against gold coins and bullion to be deposited in the Treasury of the United States.

The United States has never been on a pure gold standard (in the sense that all forms of money in circulation were secured 100 per cent by gold). But because all forms of money in circulation were readily convertible into gold on demand, and thus retained their parity with the gold dollar, the gold standard prevailed. When, however, convertibility of money into gold is either restricted or prohibited, yet the supply of money in circulation is legally related to, and, in essence, limited by the supply of monetary gold reserves, the currency of the country may be said to be on a gold basis. Since 1934 the currency of the United States has been on such an international gold basis although not convertible into gold.

6-8. Fractional Currency or Subsidiary Coins. The monetary stock of the United States also contains over a billion dollars of subsidiary coins, used for making change and coined from time to time in limited quantities to meet the general needs for such coins. These subsidiary coins are decidedly overvalued at the mint, their money value exceeding their commodity value. But they do not drive gold from circulation in accordance with Gresham's law, because their circulation is definitely restricted.

6-9. Monetary Changes Since 1933. A survey of governmental monetary as well as fiscal policies between 1933 and 1939 is necessary for an understanding of the monetary situation confronting our economy at the outbreak of the Second World War. Shortly after the Democratic administration assumed office in 1933, it began a series of important monetary changes intended initially to stimulate economic recovery after the country had continued for more than three years in the grip of the most severe business depression in its history. The continuous decline in the commodity-price level since the fall of 1929 had accentuated debt burdens payable in dollars. Business was stagnant, and upward of 12 million persons, or 25 per cent of the normally employed population, were either out of work or working only part time. Banks throughout the country were being closed because of their inability to meet demand liabilities to their depositors;[1] the mechanism of exchange was almost paralyzed.

a. Abandonment of the Gold Standard. Such a national emergency required drastic action. Realizing that something had to be done to stem the tide of price decline and to restore confidence in our banking institutions, Congress, early in March, 1933, adopted measures to abandon the gold standard. This was believed to be necessary to prevent further gold price deflation and to raise the price of gold in terms of paper dollars. Gold was no longer permitted to circulate as money in the country, and

[1] See p. 168.

the hoarding of gold was made illegal under heavy penalties. Paper money, moreover, was no longer convertible into gold at its face value.

Inasmuch as the majority of the outstanding internal long-term debts had been contracted prior to 1929, the injustice to debtors in being required to pay interest and repay principal in terms of dollars whose purchasing power was 67 per cent greater in 1933 than it had been in 1929 was apparent. In the following chapter the causes and effects of changes in the purchasing power of money, which is the reciprocal of changes in the general level of prices, will be analyzed in greater detail.

Underlying the monetary changes instituted by the Democratic administration in 1933 was the desire to restore the internal price level so that debtors might repay their debts in dollars having, on the average, the same purchasing power as those they borrowed. To accomplish this purpose, it was believed that the supply of money would have to be increased in order to lower its value. After restoring the price level, the Administration hoped to establish and maintain it with approximately constant purchasing and debt-paying power during succeeding generations.

Having abandoned the traditional gold standard, further measures were undertaken by the government to raise commodity prices by various monetary and fiscal devices. The general policy pursued was sometimes referred to by the newly coined word "reflation." Proceeding on the theory that the monetary supply of the country was inadequate to meet current needs for means of payment, Congress enacted several laws authorizing the President to take definite steps to expand the currency.

b. "Inflation" Amendment of the AAA. Under the "inflation" amendment of the Agricultural Adjustment Act of 1933, the President was authorized to determine upon a mint ratio between gold and silver, and by proclamation to provide for the unlimited coinage of both gold and silver at the ratio so fixed. This meant vesting full authority in the President by Congress to restore bimetallism in the United States, which had not existed throughout the world since 1874.

Furthermore, this amendment authorized the President to increase the volume of outstanding United States notes (greenbacks) up to 3 billion dollars, an amount about seven times the maximum of such notes outstanding at any previous time in our history. These notes were to be employed to retire a portion of the public debt by substituting small-denomination non-interest-bearing, circulating obligations for larger denomination, interest-bearing, but noncirculating government bonds. This provision, however, was not put into effect.

In the third place the President was given power to provide for expansion of currency in the form of either Federal reserve notes or deposits, by arranging for the purchase of 3 billion dollars of government bonds by the Federal reserve banks in the open market.

Finally, this amendment authorized the President to reduce the gold content of the dollar by not more than 50 per cent.

c. Nullification of the Gold Clause. By joint resolution of Congress in 1933, the gold clause in public and private contracts, stating that debts were to be paid in gold dollars of "present weight and fineness," was nullified. All kinds of United States money, including even subsidiary coins, were made full legal tender for all debts, public and private. This was, in reality, a partial repudiation of contractual obligations on the part of the government. As such, it was met with much unfavorable criticism by creditor groups.

d. Inconvertible-paper Standard. The currency of the United States was thus placed on an inconvertible-paper basis for the first time since 1879. Extensive powers were vested in the President to expand this currency with a view to raising prices. The paper dollar, for the time being, was left to seek its "natural" level in terms of gold in world markets, where it continued to depreciate. On July 15, 1933, it was at a 30 per cent discount. This gave an artificial stimulus to foreign trade. "By December [1933] the export index had advanced to 48, compared with a low of 28 in March, and the import index to 42 from the April low of 25." [1] (1923 to 1925 = 100 per cent.)

e. Gold-purchase Plan. Proceeding on the theory that commodity prices in the United States in terms of dollars would rise in direct proportion with the increase in the dollar value of gold, President Roosevelt, in October, 1933, announced to the country the government's plan to stimulate further recovery and rising prices by establishing a controlled, or governmental, market for gold.

The Reconstruction Finance Corporation, under this "gold-purchase plan," was instructed to buy gold, at home and abroad, at prices considerably above the mint price of $20.67 per ounce of pure gold, which had prevailed before the gold standard was abandoned. Payment for this gold was to be made with notes of the Reconstruction Finance Corporation, guaranteed by the government, and maturing Feb. 1, 1934. An initial issue of 50 million dollars of such notes was authorized for this purpose.

This "gold-purchase plan" was unique in monetary policy since it was obviously not intended to maintain gold price stability by convertibility but rather to change the price of unobtainable gold in terms of paper currency. Governmental monetary advisers assumed that deliberately raising the price of gold in terms of dollars would increase the buying power of foreign currencies in the United States. This, in turn, would give a much-needed stimulus to our exports and so help expand domestic buying power. Moreover, fear of further depreciation of the dollar, *i.e.*,

[1] "World Economic Survey, 1933," p. 53, U. S. Department of Commerce.

rises in domestic prices, would induce spending and thus aid in bringing about business recovery at home. Again, by raising the price of gold gradually, the basis would be laid for ultimate revaluation of the gold dollar. As noted above, under the amendment to the Agricultural Adjustment Act of 1933, the President was authorized to reduce the gold content of the dollar by not more than 50 per cent, which was the same as permitting the raising of the mint price of gold from $20.67 an ounce to $41.34 an ounce.

6–10. International Gold-bullion Standard of 1934. *a. Gold Reserve Act.* The uncertainty of our monetary policy in 1933 militated against real economic recovery in the United States. Businessmen were reluctant to make forward commitments, not knowing what the future buying power of the dollar would be. Agitation for some semblance of monetary certainty was heeded by Congress. In January, 1934, the Gold Reserve Act became law. The United States returned thereby to a partial gold basis, which was officially designated as the international gold-bullion standard.

All gold coin was withdrawn from circulation and melted into gold bars. With the approval of the President, the Secretary of the Treasury was authorized to purchase gold at home and abroad and pay for it with government funds. The Secretary, moreover, was authorized to sell, at his discretion, gold in any amounts at home and abroad. Gold certificates were made convertible into gold bullion, also at the discretion of the Secretary, but only under governmental license. This license was granted freely to Federal reserve banks whenever it was deemed necessary by the Secretary to export gold in order to settle foreign balances and to maintain exchange stability.

b. Devaluation of the Dollar. Simultaneously with the passage of the Gold Reserve Act of 1934, President Roosevelt, by proclamation, revalued the gold dollar, changing its weight from 25.8 grains, nine-tenths fine, to 15.24 grains of the same fineness or 13.71 grains of fine gold instead of the former 23.22 grains. This figure was selected to establish an official price of gold at $35 (formerly $20.67) per ounce, a 40.94 per cent reduction in the gold content of the former dollar. But this was not a 59-cent dollar, as popularly interpreted, for the dollar continued to be a 100-cent dollar. Only its gold equivalent was reduced. In consequence of this devaluation of the gold dollar, the number of new gold dollars represented by our monetary stock of gold was increased by 69 per cent.

c. Dollar Profit and Stabilization. The ownership of the additional dollars thus legally created by dollar devaluation was debatable. Most of the monetary gold of the country prior to Jan. 31, 1934, was in the possession of the Federal reserve banks, or held by Federal reserve agents, as legal reserves against Federal reserve notes and deposits of member

banks.[1] The Gold Reserve Act of 1934 provided that all rights, title, and interest of the Federal reserve banks to and in any and all gold coin and gold bullion were to be vested in the government of the United States. Credits for the number of gold dollars taken over by the Federal Treasury from the Federal reserve banks were established in the Treasury, and balances in such accounts were made payable to Federal reserve banks in gold certificates. Furthermore, the act specified that in the event the President, by proclamation, reduced the weight of the gold dollar, "the resulting increase in the value of the gold" should go to the Treasury as miscellaneous receipts.

There is an implied assumption in this provision of the law that by increasing the number of units of gold in a certain stock of gold, the value of the gold is increased. This is analogous to saying that by dividing 100 dollars into 200 half dollars and calling each a dollar, the value of the 100 dollars will be doubled. The price, but not the value of gold, was increased. It will be remembered that price is value expressed in terms of money.

The distinction between devaluating gold and devaluating the dollar must be borne in mind to avoid misunderstanding. By decreasing the weight of gold in the dollar, the value of the dollar in terms of gold and not the value of a fixed weight of gold in terms of goods is changed. An ounce of gold will change in value only as it is able to command either a larger or a smaller supply of economic goods in exchange.

In order to stabilize the international exchange value of the dollar, the Secretary of the Treasury was authorized to deal in gold and foreign exchange. For this purpose a fund of 2 billion dollars was appropriated out of the profits resulting from gold-dollar devaluation, to be under the exclusive control of the Secretary of the Treasury. As a result of dollar devaluation to 59.06 per cent of its former gold value, a profit was created for the United States Treasury estimated at 2.8 billion dollars.

6–11. Supreme Court Decision on the Gold Clause and Dollar Devaluation. In February, 1935, the United States Supreme Court, by a five to four vote, upheld the government in its nullification of the gold clause and its subsequent devaluation of the dollar. As to private contracts the court contended that:

> It requires no acute analysis or profound economic inquiry to disclose the dislocation of the domestic economy which would be caused by such disparity of conditions in which, it is insisted, these debtors under gold clauses should be required to pay \$1.69, while respectively receiving their taxes, rates, charges and prices on the basis of one dollar of that currency.

Since Congress is given the power under the Constitution to coin money and regulate its value, the majority opinion of the Supreme Court held

[1] Explained on pp. 155 and 156.

that the gold clauses in private contracts "interfere with the exertion of powers granted to the Congress."[1]

On the other hand, it was argued that, in nullifying the gold clause in obligations of the Federal government, Congress had gone beyond its power. Having authorized the issue of definite obligations for the payment of monies borrowed, it had no authority subsequently either to alter or to destroy such obligations. However, since the plaintiff against the government could not show that he had sustained any loss in buying power as a result of the devaluation of the dollar, the government was not held liable for damages, which in reality were nonexistent. "On the contrary . . . payment to the plaintiff of the amount which he demands would appear to constitute not a recoupment of loss in any proper sense but an unjustified enrichment."[2]

This raised the important question as to possible suits for damages on the part of governmental creditors holding bonds containing the "gold clause," if the price level were to rise above the level which prevailed when the obligations were incurred. The policy of the government in 1933–1934 was directed toward raising the level of prices, and, as will be shown later, the foundation for a pronounced price inflation was laid as a result of this monetary policy. If the level of prices were to rise very materially, holders of government bonds containing the gold clause would experience no great difficulty in proving damages. On the basis of the Supreme Court decision in 1935, they might then have valid ground for bringing suits.

To forestall such an eventuality, Congress, in 1935, passed the Gold-clause Act, permitting owners of gold-clause securities of the United States to receive "immediate payment of the stated dollar amount" due them. The period for making such payments expired in 1936. Those who did not avail themselves of this opportunity of converting their securities into dollars before they actually sustained losses because of a rise in the price level were barred from subsequent suit for possible damages under the provisions of the Gold-clause Act of 1935.

6–12. Revival of Silver Agitation. After the repeal in 1893 of the Sherman Silver Purchase Act of 1890, agitation for partial or complete remonetization of silver was revived from time to time. It became particularly pronounced in periods of declining prices and business depressions, when it was popularly believed that business recession was due to an inadequate supply of money. Moreover, silver producers were always ready to seize upon the opportunity to agitate for silver remonetization since, if adopted, this would widen the market for silver and so help to raise its price.

[1] *Norman v. B.&O.R.R.*, 294 U.S. 240 (1935).

[2] *Ibid.*

a. Decline in Gold Price of Silver. During the depression of the thirties the silver question again came to the fore. The gold price of silver had been declining rapidly from 1928 to 1932, which was generally believed to be due to the decreasing monetary use of silver throughout the world. Actually it was largely attributable to continued silver output as a by-product in the mining of lead, copper, and zinc, in the face of a general decline of commodity prices after 1929. This increased the supply, when there was no corresponding increase in demand for silver. However, changes in the monetary use of silver during the twenties had exerted a depressing influence on the market price of silver.

In the face of cheap silver and dear gold, it was not difficult to arouse public sentiment in favor of silver remonetization, designed to create a new market for silver and thus raise its price. Cheap money has always been looked upon by the man on the street as a cure for business depressions. The agitation to add silver to our monetary base found official recognition in the "inflation" amendment to the Agricultural Adjustment Act of 1933, previously noted. But this marked only the initial step in the partial remonetization of silver.

b. Silver-purchase Proclamation of 1933. In December, 1933, the President issued a proclamation providing for the purchase of all newly mined domestic silver for a period of 4 years. Behind this silver-purchase plan there was the desire of the Administration to raise the price of silver, partially in order to augment the buying power of silver-standard countries, particularly of China. But to check the outflow of silver, China in the fall of 1934 placed an export duty of 10 per cent on silver, and in November, 1935, abandoned the silver standard, in favor of a managed paper-currency standard. Indirectly, the abandonment of the silver standard by China was attributed to America's silver-purchase policy. It is doubtful, therefore, whether our silver-purchase program was helpful to China.

It is difficult to see how the silver-purchase plan could serve as more than a brief palliative to our own economy. Yet this silver-purchase plan was an important part of the Administration's silver policy, intended to widen the metallic base of the currency system with a view to raising domestic prices.

c. Silver Purchase Act of 1934. In June, 1934, the President approved an act of Congress known as the "Silver Purchase Act of 1934." This act authorized the Secretary of the Treasury to purchase silver, with a view to increasing the proportion of silver to gold in the monetary stocks of the United States until ultimately it should represent one-fourth of the money value of the total monetary stocks. In other words, silver purchases were to be expanded until the ratio of the monetary value of gold to silver was 3 to 1.

Section 7 of the Silver Purchase Act of 1934 provided that the President, at his discretion, could by executive order require the delivery to the

United States mints of "any or all silver by whomever owned or possessed." Exercising the authority thus vested in him, President Roosevelt, in 1934, by an executive order, required (with minor exceptions) all domestic silver bullion privately held, of more than eight-tenths fineness, to be delivered to the Treasury. Payment for this silver was to be made in government funds at the rate of 50.01 cents a fine ounce plus delivery cost at the nearest Treasury mint. Moreover, the price of domestically mined silver paid by the Treasury was raised by Congress from time to time until it reached 90.5 cents per ounce in July, 1946.

d. Remonetization of Silver. Following close upon the nationalization of domestic silver, a presidential order required that all silver acquired by the United States Treasury prior to June 14, 1934, should be remonetized (not necessarily coined) at its full mint value of $1.29 per ounce. This meant a substantial "seignorage" profit to the government, for the cost of this silver was approximately 75 cents per ounce. Approximately 62 million ounces of silver not held for redemption of outstanding certificates were thus remonetized. Silver certificates were issued against this silver. For the time being the Treasury intended to issue silver certificates against newly acquired domestic silver only to the extent made mandatory under the Silver Purchase Act, *i.e.*, to an amount equal to the cost of the silver purchased. At a later date the government might decide to issue certificates against this silver also, to its full mint value. Thus more than two and a half dollars would be created by the government for every dollar of purchase price for domestically held silver. Creating something out of nothing is a prerogative which many modern governments have exercised, avowedly in the interest of the public.

e. Critical Evaluation of Governmental Silver Policy. Economists are quite generally agreed that the silver policy of the government was dictated more by political than by monetary considerations. Economically there has been very little justification for the silver-purchase program. It represented a subsidy to silver producers at home and abroad, which gave an artificial stimulus to silver production. The silver-producing states, through effective logrolling by their skillful senators, were able to induce legislation by Congress requiring continued purchase of large amounts of silver above the market price. In consequence the government acquired over 1.6 billion dollars' worth of silver between 1933 and 1945. But in spite of these large purchases of silver, the prescribed value-ratio between silver and gold of one to three in our metallic currency was not achieved, since in the years preceding the outbreak of the war in 1939, the dollar value of gold acquired by the Treasury increased far more rapidly than that of silver.

6–13. Bank-note Currency as a Medium of Exchange. In the preceding pages the vicissitudes of metallic monies in our monetary history have been briefly traced from 1792 to date. Both gold and silver have played impor-

tant historic roles and have from time to time created weighty monetary problems. Yet, in actuality, they have, either separately or jointly, merely served as the metallic foundation of our monetary system. The prevailing media of payment in the United States for many years past have not been metallic monies, but government and bank notes and deposit currency. Such substitutes for metallic money are called credit currency.[1] Credit currency is a claim to wealth, secured either by reserves of specific items of wealth, such as gold and silver, or by such other items of wealth as the claimant may choose.

In actuality the convertibility of credit currency (notes and bank deposits) into metallic money has little significance. Most people ordinarily want to use their "money" to claim forms of wealth other than either gold or silver. As long as these claims to wealth are acceptable to those who have economic goods to sell, they serve as effective media of exchange. They may, therefore, be issued by either those public or those private agencies that control sufficient wealth to meet their outstanding legal monetary claims.

Bank notes are promises to pay, on the part of the issuing bank, a specified sum to the bearer on demand. Their issue is usually subject to careful governmental regulation, in order to prevent their excessive expansion, which would cause them to depreciate in value.

In practice, either private banks or governmental treasuries have served as agencies for the issue of credit currency. Where a government permits private banks to pledge, as security, items of wealth or claims to wealth entrusted to them by stockholders and depositors, they may issue bank notes, which will serve as an acceptable medium of exchange. Thus bank notes formed a significant part of the circulating medium of this country for a century or more. In European countries bank notes represent the prevailing form of money in circulation. In the United States, however, their significance as a circulating medium decreased in relative importance during the period between the First and the Second World Wars.

Despite the great increase in outstanding currency as a whole from 1939 to 1945, as shown in section 6-3, the volume and value of national bank notes actually declined. There was, however, considerable increase meanwhile in Federal reserve bank notes, but it may be temporary. During this same period the output and circulation of Federal reserve notes increased tremendously with the rapid expansion of governmental borrowing during the war. This situation constituted a continued and serious threat of inflation. Federal reserve notes, as will be seen presently, are not bank notes in the strict sense of the word. Bank deposits, as credit currency, will be discussed in Chap. VIII.

[1] Credit currency, whether originating with governments, central banks, or private banks, is also called "credit money" by some economists.

6–14. Development of National Bank-note Currency in the United States. Under the Act of 1863, establishing our national banking system, national banks were required to buy government bonds, against which they could issue bank notes up to 90 per cent of the par value or market value of these bonds, whichever was smaller. After 1900, these national bank notes could be issued up to the par value of the bonds, but not in excess of the capital of the issuing bank. As an incentive to state banks to become members of the national banking system, Congress passed a law in 1865 imposing a tax of 10 per cent on all notes issued by state banks. This made it unprofitable for state banks to continue to issue bank notes. National bank notes, therefore, became the only type of bank note in circulation.

Although national bank notes enjoyed wide circulation in the past, nearly 900 million dollars being outstanding on Dec. 31, 1934, their relative importance as a circulating medium was decreasing after 1913 with the growing circulation of Federal reserve notes. National bank notes were a rather inelastic medium of exchange, not expanding or contracting readily to meet the requirements of business, since their issue was limited by available government bonds with circulating privilege.

In August, 1935, the Treasurer of the United States began to retire outstanding national bank notes, even though such notes had formed a part of the circulating medium since the time of the Civil War. To do this it was merely necessary for the government to call in the two Federal bond issues having national-bank-note-circulation privilege. The government paid for these bonds with a part of the profits realized from the revaluation of the gold dollar in 1934. Gold certificates were issued to the Federal reserve banks for a corresponding amount of Federal reserve notes. These Federal reserve notes were then exchanged for national bank notes as they were withdrawn from circulation. By the end of 1947 less than 104 million dollars of national bank notes were still outstanding.

6–15. Federal Reserve Bank Notes. The Federal Reserve Act of 1913 contemplated the gradual retirement of the national bank notes. The Federal Reserve Board (now Board of Governors) could require Federal reserve banks to purchase the bonds that had secured the national bank notes to an amount not to exceed 25 million dollars of such bonds in any year. Upon the deposit of these bonds with the Treasurer of the United States, Federal reserve banks could receive circulating notes equal in amount to the par value of the bonds so deposited. These Federal reserve bank notes were issued and redeemed under practically "the same terms and conditions as national bank notes." The authority to issue further Federal reserve bank notes, however, was terminated by Congress in June, 1945. But nearly half a billion dollars of these notes were still in circulation at the end of 1945. These had been issued primarily to aid in

war financing, for, when we entered the war in December, 1941, less than 20 million dollars of Federal reserve bank notes were in circulation. At the end of 1947, about 400 million dollars worth were still outstanding, but their volume was slightly less than in 1945.

With the eventual withdrawal of national bank notes and Federal reserve bank notes from circulation, the currency system of the United States will be much further simplified. At present (1948), Federal reserve notes and silver certificates are the chief forms of paper money in general circulation. Their expansion and contraction are under direct governmental control.

6–16. Federal Reserve Notes. To provide an elastic currency, the Federal Reserve Act of 1913 authorized the issue of a new type of money in the form of Federal reserve notes, at the discretion of the Federal reserve banks, through Federal reserve agents. These currency notes are issued not only against the security of government bonds, as were national bank notes, but also against collateral security arising out of sound commercial transactions, such as drafts, bills of exchange, bankers' acceptances, trade acceptances and the like, and gold certificates.

Federal reserve notes are a direct obligation of the Federal government; although issued by Federal reserve banks they are not mere bank currency. The act, however, is neither consistent nor explicit on this point. It says that Federal reserve notes are "to be issued at the discretion of the Federal Reserve Board" and that they "shall be obligations of the United States." Again, it speaks of them as "issued to the bank" but not by a Federal reserve bank. On the other hand, the act contains such phrases as "Federal reserve notes issued through one Federal reserve bank," etc.

Federal reserve notes are technically issued by the United States government. Federal reserve banks apply to the Federal reserve agents for the amount of notes they require and furnish the collateral security and gold certificates. As previously indicated, Federal reserve notes are obligations of the United States, are "receivable by all national and member banks and Federal reserve banks for all taxes, customs, and other public dues," and are redeemable in lawful money on demand at the Treasury of the United States.

Federal reserve banks to which these notes are issued were formerly required to maintain at least a 40 per cent reserve in gold certificates against the notes in actual circulation, and the balance in commercial paper or in United States government bonds. In 1945 the reserve requirements in gold certificates were reduced to 25 per cent.

6–17. Elastic Currency through Federal Reserve Notes. Federal reserve notes provide an elastic currency, which was lacking under the national banking system before 1913. National bank notes, as just explained, could be issued only against the security of certain government

bonds. Federal reserve notes, on the other hand, can be issued against the security of government bonds and commercial paper arising out of business transactions, plus gold certificates. As business expands and new wealth is produced, further credit in the form of deposit currency can be obtained by businessmen to finance the needs of industry by making loans from their banks, using their own commercial paper as collateral. Commercial banks, in turn, may take their acceptable commercial paper for rediscount to their Federal reserve bank; and the Federal reserve bank can, if needed, obtain currency in the form of Federal reserve notes by depositing acceptable commercial paper and gold certificates with its Federal reserve agent, against which he will issue these currency notes. Thus it is seen that this paper money is secured by newly created wealth, as well as by actual gold.

But even before our entry into the Second World War, the importance of commercial paper among the earning assets of commercial banks had declined more and more, while banks increased their holdings of United States government securities. Consequently the collateral security behind Federal reserve notes existed, to an ever-increasing extent, of government securities, rather than of commercial paper. This trend was magnified by the abnormal monetary demands incidental to financing the Second World War. Holdings of government securities by Federal reserve banks increased from 2.255 billion dollars in December, 1941, to 24 billion dollars in December, 1945, while Federal reserve notes in circulation rose from 6.7 billion dollars to 24 billion dollars during the same interval. The elasticity of Federal reserve notes to meet the needs of war financing was thus effectively demonstrated.

Elasticity of currency, however, implies more than mere ability to expand in accordance with production requirements, whether they pertain to peacetime output of civilian goods, or to the production of implements of war. It also involves the ability to contract excess currency when it is no longer needed by business. The Federal Reserve Act of 1913 provided for the more or less automatic retirement of Federal reserve notes when they became redundant. Under peacetime conditions, when the demand for these notes on the part of individuals and business units fell off, the surplus notes would normally find their way back into the reserve banks when loans were repaid. They could be withdrawn from circulation when member banks deposited them with the Federal reserve banks through which they had been issued.

But as a result of war finance, Federal reserve notes issued against the security of government bonds, rather than against commercial paper, will not necessarily or naturally contract with probable decline in business activity after the war. They will, therefore, continue to represent an excessive supply of currency brought about by war finance, which, if it is to

be contracted, must be done by government repayment of debts. But the proceeds to do so would not be derived from "self-liquidating" commercial paper, but primarily from Federal tax revenues. Our Federal fiscal program is thus vitally related to our monetary policy.

6–18. Maintaining the Parity of Different Kinds of Money. Prior to the abandonment of the gold standard in 1933, parity or equivalence in value between gold coin and gold bullion was maintained automatically by free convertibility of one into another. If the gold dollar became worth more than 23.22 grains of fine gold, gold could be bought in the commercial market and brought to the mint to be coined until the tendency was checked. This would increase the monetary supply of gold relative to the commercial supply. Consequently, the value of gold at the mint would tend to decline while its commercial value would rise until the mint and market values were about the same. On the other hand, if gold in the markets of the world was worth more as bullion than the dollar into which it was coined, gold coins would be melted down and used as bullion until the mint and commercial values of gold once more became approximately the same.

The parity between gold coin and the various forms of money in circulation in the United States was maintained by virtue of their ready convertibility into gold coin. But this was changed when the United States abandoned the gold standard in 1933. The "gold clause" in contracts, as previously indicated, was nullified by the government, and all dollar obligations were made payable in lawful money of the United States. Whereas formerly all forms of currency were kept on a par with gold coin by virtue of their ready convertibility into gold, after 1933 the money in circulation was convertible on demand only into other lawful money. In other words, a person in possession of a certain number of Federal reserve notes, or United States notes, could no longer demand gold coin for the face value of these notes, but, on demand, would receive either the one or the other of the same kind of notes that he was holding.

6–19. Monetary Inflation. Monetary inflation may be said to occur when the supply of money expands more rapidly than the supply of salable goods, thus exerting an upward pressure on prices. The many monetary changes since 1933 widened the base of our monetary structure in several ways. In the first place, gold-dollar devaluation increased the number of gold dollars in our monetary reserves by 69 per cent, and gave a stimulus to the large inflow of gold in the years preceding the Second World War. Secondly, silver was added to our metallic money base by the partial remonetization of silver. The large silver purchases since 1933, as noted before, added upward of 1.6 billion dollars to our stock of monetary silver. In the third place, many of the legal reserve requirements

against the expansion of credit currency became rather meaningless, since these reserves were in "lawful money," and all forms of money, whether metallic currency, United States notes, or Federal reserve notes, were made lawful money. Lastly, as previously shown, the gold-certificate reserve ratio of Federal reserve banks against Federal reserve notes was reduced in 1945 from 40 per cent to 25 per cent.

These monetary innovations since 1933 made possible not only widening our metallic monetary base, but also expanding credit currency established on this base. The monetary stock in the United States, which on Feb. 28, 1933, amounted to about 10.3 billion dollars, totaled 24.8 billion dollars on Sept. 30, 1939. This represented an increase of 140 per cent, while the national income increased only 65 per cent during the same interval. Thus the total stock of money in the United States increased more than twice as rapidly as the national income between 1933 and 1939. But as long as a large part of this additional money lay idle as excess reserves, it did not have an inflationary effect on prices, even though it did have inflationary possibilities.

The inflation potential, previously created, became effective in our economy after we had embarked on our vast war program. Expansion of the supply of money to pay for war goods, once our productive resources were fully utilized, began to exert an upward pressure on prices and eventually led to the introduction of general wartime price controls and rationing of essentials. But as long as the supply of money expanded more rapidly than the supply of salable goods, the inflation potential became a growing menace to costs of living. General price control, with a view to holding down prices, may be viewed as a form of concealed inflation. It would obviously not have been needed if prices had not threatened to rise above price ceilings in the absence of such control.

While many persons in our war economy accumulated more and more monetary spending power, this spending power has buying power only if it is able to command those goods wanted by the people. The substantial postwar rise in prices of goods demonstrated what previously had been seen in black markets, namely, that the accumulated supply of currency growing out of wartime activity has lost some of its usefulness as a store of value. A major problem in our postwar economy is to devise a medium of exchange that will have reasonable stability of value. An excessive supply of money, relative to demand for it, represents the real inflation potential, which was expanded in our war economy although its foundation had been laid in the early monetary innovations of the New Deal.

Various proposals for dealing with this problem of inflation and deflation will be examined in subsequent chapters devoted to private and public finance.

Guide Questions on Text

1. What are the functions performed by money?
2. Is it possible to have a standard of value that is not the medium of exchange? Explain.
3. How may money be classified?
4. Explain the several kinds of money in the United States and show how they came into circulation.
5. Distinguish between monometallism and bimetallism.
6. Explain Gresham's law and illustrate how it operates.
7. What are the characteristics of the gold standard?
8. Explain the changes made in our monetary system since 1933.
9. Evaluate critically the theory underlying gold-dollar devaluation.
10. Was the value of gold or the value of the dollar decreased when the price of gold was officially raised from $20.67 per ounce to $35.00 per ounce? Explain.
11. What is the monetary standard of the United States?
12. Summarize the consequences of gold-dollar devaluation.
13. Explain the meaning of silver remonetization.
14. Criticize the silver-purchase policy of the Federal government.
15. Trace the development of bank-note currency in the United States.
16. Distinguish between national bank notes, Federal reserve bank notes, and Federal reserve notes.
17. "Federal reserve notes provide an elastic currency." Explain.
18. How is parity among the different kinds of money in circulation in the United States maintained?
19. What is meant by monetary inflation?
20. How did the various monetary reforms since 1933 lay the basis for currency inflation?
21. What evidence of currency inflation existed after the close of the Second World War?
22. How does an understanding of the development of our monetary system aid in dealing with the problem of devising a reasonably stable medium of exchange in our postwar economy?
23. What is meant by the inflation potential? Of what does it consist? Why is it dangerous?

Topics for Investigation

1. Efforts to restore an international gold standard in the interwar period.
2. Causes and effects of the breakdown of the gold standard in the thirties.
3. Economic consequences of silver remonetization.
4. Critical evaluation of proposals for achieving monetary stability.
5. Alternative methods of controlling the supply of money.
6. Popular money fallacies.

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See also Selected References, Chap. VII.

CHAPTER VII

UNSTABLE PRICE LEVELS

7–1. Purchasing Power of Money. Money that does not have the same purchasing power over a period of time lacks the most fundamental characteristic of a good medium of exchange, *i.e.*, stability of value. By the purchasing power of money is meant its ability to obtain for its possessor control over economic goods.

In our peacetime economy most economic goods produced find their way to markets in one form or another, there to be exchanged for other goods. Even the value of capital goods is ultimately incorporated in the prices of marketable consumers' goods. The process of exchanging or trading economic goods is called buying and selling. Goods are bought for money and sold for money. Money measures the exchange value of goods. It is the common denominator, in terms of which the relative values of marketable items are expressed. Values thus interpreted in terms of money as previously noted are called prices.

At any one instant of time, our monetary unit, the dollar, serves as an accurate measure of value, for then it truly expresses the value relationship between economic goods. Thus, when we say a hat sells for $5, while a suit of clothes sells for $40, a value relationship of 1 to 8 has been established, in money terms, between the hat and the suit of clothes since the price of the hat is one-eighth that of the suit of clothes. Where such value relationships have been determined in open competitive markets, money may be viewed as indicating the coefficient of choice or preference.

In our present-day economy, whether in wartime or in peacetime, a great many exchange transactions take place in which money payments are deferred to a later date. In other words, goods are bought and sold on credit. Particularly in times of war, governments buy extensively on credit, as indicated in the rapidly mounting national debt during the Second World War. By credit is meant a promise to pay in the future the equivalent for value received in the present. As indicated in the preceding chapter, credit currency, as a means of payment, consists of government and bank notes, as well as bank deposits.

Credit injects the element of time into exchange transactions. Consequently it becomes a matter of paramount importance, as will be seen later, that over a period of time money should possess stability of value.

As a rule, credit transactions are expressed in money terms. For example, a person purchases a $1,000 bond, repayable by the debtor at the end of 10 years, with interest at 4 per cent annually during the interim. If the purchasing power of the dollar either increases or decreases in this 10-year period, our creditor will receive at maturity correspondingly more or less in real purchasing power than he lent.

Long-term contracts, involving dollar obligations extending over generations—mortgages, bonds, ground rents, insurance contracts, public debts, etc.—emphasize the important function of money as a standard of deferred payments and the seriousness of changes in the value of the dollar.

Past experience has amply demonstrated that the purchasing power of the dollar has fluctuated widely. This fluctuation is reflected in changes of the general price level over a given period of time. Since the beginning of the last century wars have been major disturbing influences on the price level; but the long intervals of peace between them also show pronounced variations in the purchasing power of the dollar.

7-2. Measuring Changes in the Purchasing Power of Money by Means of Index Numbers. *a. Method.* Studies of changes in the purchasing power of the monetary unit are made by compiling index numbers. An index number of prices may be defined as a comparison of the average relative prices of a representative group of items at any one time with the average relative prices of a similar group at another time, the latter taken as the base, or 100 per cent.

In preparing index numbers it is customary to "weight" the various items whose prices are included in the average, in order to measure their relative importance. For example, without such weighting, an increase of 50 per cent in the price of newspapers—let us say, from 2 to 3 cents over a period of time—would have a greater effect upon the composite relative price index than a 33⅓ per cent increase in the price of automobiles—say, from $900 to $1,200. The price of each commodity or item included in the aggregate index must therefore be carefully weighted. This may be done by taking the average price of each item over a period of time, *e.g.*, a year, and multiplying it by the estimated quantity marketed during that period. When prices of individual items included in an index number are thus weighted, their sum will give a fairly accurate aggregate of prices for comparison with similar aggregate prices computed at different time intervals.

b. Formula. The following formula for computing index numbers is widely used:

$$I = \frac{\Sigma P_1 Q_0}{\Sigma P_0 Q_0}$$

In this formula P_1 represents the prices of the several items at a given time; P_0, the prices of similar items in the base year; Q_0, the quantities

marketed, which are assumed to be the same in both years; Σ, the sum of the weighted items; and I, the computed index.

c. *Illustration.* Let us assume that in a certain marketing area the average retail prices as shown in Table 2 were charged for the designated quantities of five items of men's wear of standard quality in 1926 (the base year) and in 1946.

TABLE 2. COMPUTATION OF INDEX

Items	1926 Average price, P_0	1926 Quantities sold, Q_0	1926 Price × quantity, P_0Q_0	1946 Average price, P_1	1926 Quantities sold, Q_0	1946 Price × quantity, P_1Q_0
Suits	$25.00	1,000	$25,000	$40.00	1,000	$40,000
Shirts	2.00	5,000	10,000	2.50	5,000	12,500
Ties	1.00	8,000	8,000	1.50	8,000	12,000
Shoes (pr.)	7.00	2,000	14,000	8.00	2,000	16,000
Socks (pr.)	0.75	10,000	7,500	0.75	10,000	7,500

$$\Sigma P_0Q_0 = \$64{,}500 = 100 \text{ per cent} \qquad \Sigma P_1Q_0 = \$88{,}000$$

$$I = \frac{\$88{,}000}{\$64{,}500} = 136.4 \text{ per cent}$$

Thus, under the assumed conditions, the average retail level of prices of the five items used in the computation increased from 100 in 1926 to 136.4 in 1946, or by 36.4 per cent.

Changes in market value of individual items in an index number over a period of time give no indication of possible changes in the quality of the items included in the index. Thus, the price of a pair of socks in 1946 may have been the same as the price of a pair of socks in 1926, but this is no accurate indicator of the quality of the product at different periods of time.

7-3. Changes in the Levels of Prices. The wholesale-commodity-price index, compiled by the U. S. Bureau of Labor Statistics, is perhaps the best known and most widely consulted price index in the United States. It comprises 889 carefully selected and grouped commodities, whose prices are based on primary market quotations. The index is computed with the aid of the above formula.

This index alone, however, does not serve as an accurate measure of changes in the purchasing power of money. Many other items enter into everyday monetary exchange transactions, that are not included in the wholesale-commodity-price index. A general price index, intended to show the changes in the purchasing power of money, would include not

TABLE 3. INDICES OF WHOLESALE COMMODITY PRICES, COST OF LIVING, AND THE PURCHASING POWER OF THE CONSUMERS' DOLLAR *

(Annual Averages, Converted to 1926 Base = 100)

Year	Wholesale commodity prices	Cost-of-living index	Domestic purchasing power of the consumers' dollar
1900	56.1	39.9	250.4
1901	55.3	41.7	239.8
1902	58.9	42.8	233.6
1903	59.6	43.4	230.4
1904	59.7	43.9	227.7
1905	60.1	43.9	227.7
1906	61.8	45.7	218.8
1907	65.2	47.4	211.1
1908	62.9	48.5	206.2
1909	67.6	51.9	192.7
1910	70.4	54.8	182.5
1911	67.9	54.8	182.5
1912	69.1	58.2	171.8
1913	69.8	57.1	173.8
1914	68.1	59.7	168.2
1915	69.5	59.9	167.3
1916	85.5	64.4	155.2
1917	117.5	76.5	130.7
1918	131.3	89.2	112.1
1919	138.6	100.8	99.2
1920	154.4	115.0	87.0
1921	97.6	98.9	101.1
1922	96.7	93.7	106.7
1923	100.6	96.3	103.8
1924	98.1	97.8	102.2
1925	103.5	100.0	100.0
1926	100.0	100.0	100.0
1927	95.4	98.0	102.0
1928	97.7	96.9	103.1
1929	95.6	96.3	103.8
1930	86.4	94.4	105.9
1931	73.0	86.0	116.3
1932	64.8	77.2	129.8
1933	65.9	73.2	136.6
1934	75.0	75.7	132.1
1935	80.0	77.6	128.9
1936	80.8	78.4	127.6
1937	86.3	81.2	123.2
1938	78.6	79.7	125.5
1939	77.1	78.6	127.1
1940	78.6	79.2	126.3
1941	87.3	83.2	120.2
1942	98.8	92.2	108.5
1943	103.1	97.8	102.2
1944	104.0	99.3	100.7
1945	105.8	101.6	98.4
1946	121.1	110.1	89.1
1947	151.7	125.9	79.5

* Indices adopted from compilations by the U. S. Bureau of Labor Statistics converted to a common base year (1926) by the authors.

merely wholesale commodity prices, but also retail prices of consumers' goods reflecting the cost of living. Furthermore, it would include indices of wage payments and interest rates, showing the prices paid for the services of labor and of capital, respectively. Other items, such as rentals, security prices, and building construction costs, also would be considered in a composite general price index. Such a composite or general price index, however, does not indicate how changes in purchasing power of money affect any one group or class of purchasers. A less inclusive cost-of-

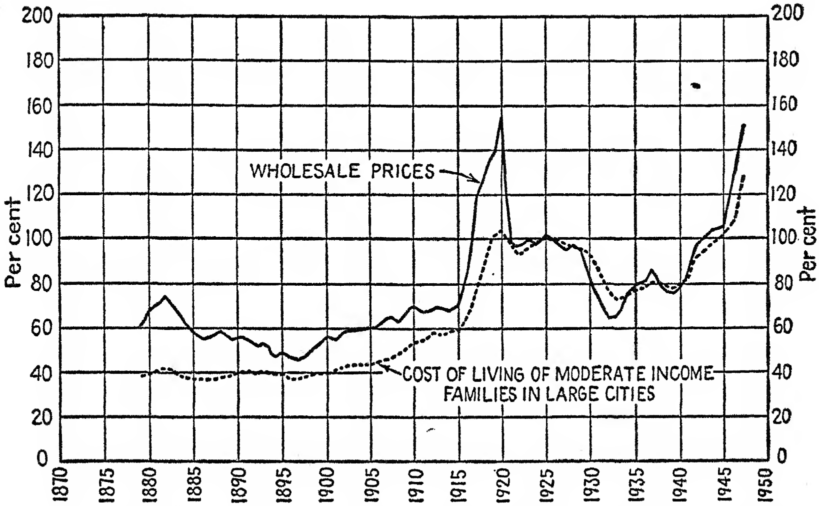

CHART 4. Movement in cost-of-living index and wholesale commodity prices in the United States from 1879 to 1947. Base (= 100 per cent) is 1926 level.

living index is more representative than a more general composite price index of changes in the purchasing power of money, as it affects the masses of consumers.

Table 3 presents the Bureau of Labor Statistics' wholesale commodity-price index and cost-of-living index since 1900, as well as the reciprocal of the latter, expressing the domestic purchasing power of the consumers' dollar.

These indices reveal wide fluctuations in the purchasing power of the dollar, both while the United States was on the gold standard prior to 1933, and since the gold standard was abandoned. Wholesale commodity prices and costs of living rose steadily in the early years of the present century, and then jumped to a peak during the First World War, after which they declined to the low depression levels in the early thirties. They rose again in the late thirties and continued to move upward to date (1948). But despite great fluctuations in price levels from crests to troughs, the long-

run trend of prices has been upward, *i.e.*, the dollar has tended to depreciate in value.

Since the buying power of the consumers' dollar in American cities was two and a half times as great in 1900 as in 1945, a $2,000 salary at the turn of the century was the equivalent of a $6,200 salary in real income in 1947. The dizzy dance of the dollar at wholesale and at retail prices is shown in Chart 4 on the preceding page.

7–4. Changes in Individual Values. The value relationship among the component items in an index, such as the cost-of-living series, may conceivably remain the same, while the composite index of the cost of living either rises or falls. If the prices of all individual items included in the index rose or fell uniformly and proportionately, the value relationship among the separate items would remain unchanged. Only the value of money, *i.e.*, its general purchasing power, would have been reduced or increased. On the other hand, although the value relationship among all the items in the index numbers, *i.e.*, the coefficient of choices, were altered, the composite index number might conceivably remain the same. The prices of some goods would have risen, while others would have declined.

The inertia of some prices, whether due to habitual action of buyers, price control, or to governmental price regulation, on the one hand, and the sensitivity of other prices, due to active competition in open markets, on the other, all contribute to continuous changes in the value relationships among individual items. While the price of bread may be rising, the price of eggs may be going down, and that of butter may remain unchanged. But this does not necessarily mean that the amount of money spent for a composite supply of bread, eggs, and butter has changed. Under peacetime conditions in our economy this merely indicates a change in the supply of, and/or the demand for, each individual item. Only when the aggregate average of prices, whether at wholesale or at retail, moves either upward or downward over a period of time does it indicate a change in the buying power of money.

This is equally true whether the monetary unit is the pound sterling, the franc, or the dollar. The monetary units of all countries, whether based on metallic currency as the standard of value or on an inconvertible-paper standard, have been very unstable in the past. They have been flexible and not fixed measures, such as the yard, the pound, and the gallon. Over a period of time, monetary units have not served as accurate measures of value because their own values have changed meanwhile.

Changes in the value of money, as reflected in fluctuations in the price levels, create many serious economic problems since they do not affect all prices or price groups entering into the price index at the same time and with the same intensity. Hence they impair the effectiveness of money as a standard of deferred payments.

7-5. Effects of Changes in the General Level of Prices. The most marked effect of changes in price levels can be observed between debtor and creditor classes. A rise in the purchasing power of money, *i.e.*, a general fall in the average of prices, benefits creditors; while a fall in the purchasing power of money, *i.e.*, a rise in aggregate prices, benefits debtors.

When prices fall between the time of contracting an obligation and the time for its repayment, the debtor returns an amount of money to the creditor which will purchase more economic goods than he received; when prices rise, the debtor returns the monetary equivalent of fewer economic goods than he received. Over a short period of time, and with but a slight change in the level of prices, the losses thus sustained by either debtors or creditors may be insignificant; but with such extensive changes in the price level as were experienced in the United States during its entire history, the losses incurred alternately by the debtor and the creditor classes attain considerable importance.

Moreover, modern industries frequently contract debts maturing many years hence. Even a gradual but uncertain change in the level of prices during the interval between incurring the obligations and their final repayment may mean considerable loss either to debtors or to creditors. If a noncallable investment had been made at the turn of the century and had matured in 1945, the debtor could have repaid his debts with dollars whose buying power at retail was only about one-third of that of the 1900 dollar.

Not only the debtor and the creditor classes are affected by changes in price levels. Ordinarily, in periods of rising prices, business profits increase since many production costs, such as wages, rentals, and interest on capital, tend to lag behind the advancing selling prices of products. Wages may be paid under a wage contract extending over a period of time, during which they may not be adjusted promptly or proportionately to rising prices. Rentals are usually established at a fixed amount for a year or more, in accordance with the terms of the lease; similarly, funds may be borrowed at a fixed rate of interest for a long period of years. Salaries likewise usually advance more slowly than does the price level, whether at wholesale or retail.

On the other hand, in a period of falling prices, the wage earner and the salaried man may be benefited, because wages usually do not fall so far or so fast as the level of prices recedes. But at the same time, the workers are subjected to the risk of unemployment, because business depression often accompanies deflation. It is a well-established observation that during a business depression, when prices tend to decline, unemployment increases conspicuously. Those who receive a fixed monetary income in the form of rentals, interest, or annuities will gain in their control over economic goods as prices fall. On the other hand, deflation and depression

bring losses to enterprisers and cuts in dividends to stockholders. The serious effects of changes in the purchasing power of our money upon all economic classes emphasize the desirability of a more stable currency than has existed in the past.

7-6. Why the Value of Money Changes. *a. Gold Standard.* As long as the United States was on the gold standard, permitting the free and gratuitous coinage of gold, the value of gold money, for reasons previously explained, tended to be the same as the value of gold bullion. Consequently, ordinary supply and demand forces that caused the value of gold bullion to change in the commercial market also caused its monetary value, *i.e.*, its purchasing power, to change correspondingly. In the long run, a decline in the value of gold, owing primarily to its increased supply, meant a rise in the general price level. But an increase in the value of gold because of its scarcity relative to an increasing demand for gold was the same as a fall in the general price level. This was necessarily so, as long as prices were expressed in terms of a gold monetary unit, and as long as money could be converted into gold.

b. Inconvertible-paper Standard. When convertibility into gold is distinctly limited by law, as in the United States since 1934, or abolished entirely, the supply of gold becomes ineffective as a determinant of the value of money. Then the supply of money will be limited not by either the cost of new gold production or the available stock of gold but by governmental monetary policy. Price levels will therefore be dependent upon the nature and extent of control exercised by the government over the expansion or contraction of lawful money, as well as by the confidence the public has in the continued acceptability of this money. Loss of faith in an inconvertible paper money leads to a flight from such money into goods, resulting in a rise in prices, *i.e.*, a decline in the value of the money. But when the government exercises effective control over the supply of money, an inconvertible paper currency, not anchored to gold reserves, may provide a satisfactory medium of exchange within a country. The value of such paper money will fluctuate with changes in its supply relative to demand, even as in the case of metallic currency. An increase in monetary supply without a corresponding increase in its demand will cause the value of the monetary unit to decline. On the other hand, a decreased supply without a corresponding decline in monetary demand will result in a rise in the value of money.

7-7. Public Faith in the Dollar. Monetary habits underwent a profound change between the First and the Second World War, both in the United States and abroad. The withdrawal of gold coin from circulation and the substitution of credit currency, which attained general acceptability whether convertible into gold or not, reflected these changes in monetary habits.

Few people in the United States trace the value of their money, in the form of either currency notes or bank deposits, to the gold reserves in the United States Treasury. Their money derives acceptability from the fact that it will buy things and not from any metallic reserve into which it may or may not be converted. This has been clearly demonstrated in the United States since 1933, when the gold standard was abandoned. People did not lose faith in the dollar, even though it was no longer convertible into gold.

The excessive supply of currency in circulation, growing out of governmental war financing, threatened to lead to a loss of faith in the dollar at the close of the war. This was indicated in the upward trend in the price level, which, when no longer held in check by continued government price controls, led to a rapid decline in the value of the dollar.

7-8. Equation of Exchange. It has been pointed out before that the value of money is determined by the interaction of the forces of supply and demand. Governmental financing and banking policies controlling the supply of credit are the basic present-day determinants of the supply of our medium of exchange. On the other hand, the monetary habits of people, expressed either by spending or by not spending, influence the demand for money in one form or another. But, as money is spent to buy commodities and services, we may also view the supply of money as a potential demand for goods. Conversely the demand for money may be regarded as synonymous with the supply of goods sold for money.

Over a period of time, however, a dollar may buy more than a dollar's worth of goods, depending on the number of times it is used in exchange. It may be spent by one person to buy a meal; the recipient may then use it to buy vegetables from a farmer; the farmer, in turn, may use it to pay the hired help, and so on. Thus the rate of turnover of money, or its velocity of circulation, must be taken into consideration in determining the aggregate supply of circulating media used in exchange transactions.

The relationship between the supply of and the demand for money in circulation, which interprets the purchasing power of money in the broad sense of the word to include all forms of circulating currency, may be expressed algebraically by the following equation:

$$\frac{MV + M'V'}{T} = P \qquad \text{or} \qquad MV + M'V' = PT$$

M represents the stock of lawful money, V its velocity of circulation, M' the deposit currency in circulation, V' its velocity of circulation, T the total quantity of commodities and services traded, and P the average price level of these economic goods.

7-9. Interpretation of the Equation of Exchange. The major portion of lawful money M in the United States is ordinarily in circulation. That

portion which is held as legal reserve, and which is not in circulation, has a zero velocity; consequently it will not directly affect the level of prices P. Legal-reserve requirements, however, govern the total amount of deposit currency; and they also ultimately limit the circulating amount of lawful money. Thus indirectly, through their influence on both M' and M, legal reserves will affect the price level.

Broadly interpreted, the equation of exchange is a truism, for it merely states that the number of dollars in circulation multiplied by the frequency with which they change hands in a given period equals the average prices of the goods bought and sold, times their quantity. But the equation of exchange helps to visualize the several items that affect the level of prices and, hence, the value of money. Other things remaining equal, an increase in either primary or credit currency in circulation over a period of time will tend to raise the level of prices, while a decrease in these items will tend to lower it. On the other hand, an increase in the quantity of goods bought and sold without either a corresponding increase in the circulating media or in their velocity of circulation will tend to lower the price level.

7–10. Significance of Credit Currency. As previously pointed out, that portion of M which consists of either gold bullion or gold coin has been largely withdrawn from monetary circulation in former gold-standard countries, including the United States. Currently (1948) it performs the secondary monetary function of a reserve for the extension of credit currency. Assuming that credit currency has been issued and put into circulation to the full extent of the minimum legal gold-reserve requirements of a country, a large net inflow of gold may encourage the expansion of credit currency issued against this gold. To induce borrowing, bankers might lower their discount rates on loanable funds made available by the gold influx.

If continued over a period of time, credit currency expansion based on an increased supply of monetary gold would tend to raise prices, particularly after full employment of productive resources had been reached. On the other hand, a net outflow of gold from a country would necessitate the contraction of credit currency by calling in loans if credit had previously been expanded to the limit of reserve requirement. The resultant deficiency in funds to meet the needs of business would lead to higher money rates, and, if continued long enough, to a downward trend in commodity prices.

But this analysis is predicated on the assumption that circulating credit currency, in the form of either currency notes or demand deposits, has been expanded and used to the full extent of the minimum of legal gold-reserve requirements. This has by no means always been the case in our monetary experience. At the time of our entry into the war in 1941, com-

mercial banks of the United States had idle money reserves of 3.5 billion dollars in excess of legal-reserve requirements.

Under such conditions it is apparent that either an increase or a decrease in reserve gold holdings will not bear directly on the supply of credit currency serving as the circulating medium. Whenever this is the case, the quantity of M', or credit currency, will be dependent not on the available gold or gold-certificate reserves in the central banks of the country but on the demand for additional loan funds from banks.

7-11. Different Ways of Stabilizing the Value of the Dollar. The problem of stabilizing the value of the dollar thus becomes one of regulating the volume and flow of our circulating media so as to establish a definite ratio between them and the volume and flow of commodities and services bought and sold for currency. Whereas in former years price-level analysis was concerned primarily with the quantitative factors in the equation of exchange, more recent analysis, influenced largely by the writings of the British economist John Maynard Keynes, stresses the flow of money income and outgo over a period of time. It is a dynamic rather than a static approach to the study of monetary stabilization. But the quantitative analysis by the classical economists and the modern money income flow interpretation of the effects of changes in the supply of money on the level of prices are not contradictory. They are merely different approaches to the common objective of economic stabilization through monetary management, *i.e.*, of maintaining a continued balance between production and consumption at optimum employment.

7-12. Quantity Theories of Money. Quantitative proposals for stabilizing the purchasing power of the dollar by regulating the monetary supply to meet the requirements of business have been advanced by various economists. They are generally based on the assumption that in the equation of exchange the ratio between the velocity of circulation of deposit currency and the volume of goods bought and sold over a period of time is fairly constant. Moreover, they assume that price initiates no changes in the other items in the equation of exchange, but is a purely passive factor in the equation.

Statistical studies made from time to time in the United States, pertaining to the velocity of circulation of bank deposits and the volume of trade over a period of years, indicate a high degree of correlation between these two items "both with regard to the time movement and the amplitude of the fluctuations,"[1] and so warrant the above assumption. Moreover, long-run changes in price levels under the gold standard correlate significantly with changes in the supply of monetary gold, after allowing for a certain time lag. Hence, it has been maintained by so-called "quantity" theorists that changes in the level of prices may be traced to changes in the

[1] Snyder, Carl, "Business Cycles and Business Measurements," p. 15.

supply of circulating media. They propose, therefore, to counteract price changes as reflected in index numbers by either expanding or contracting the quantity of circulating media, with a view to stabilizing the purchasing power of money.

Proposals to regulate the outstanding supply of lawful money authorized by the government, with a view to price stabilizing, will be discussed in this chapter. The problems of controlling and regulating deposit currency and banking functions in general will be outlined in the following chapter.

7-13. Secular and Cyclical Price Changes. In considering fluctuations in general price movements, it is also necessary to stress the difference between secular and cyclical changes in price levels. The problem of controlling cyclical price fluctuations is essentially one of effectively regulating the expansion and contraction of deposit currency.[1] On the other hand, stabilizing the long-run or secular trend of prices necessitates some control over the supply of standard or lawful money, serving largely as the legal reserve for the expansion of deposit currency.

Unsound monetary proposals, intended to stabilize prices, have grown out of a confusion of the cyclical and secular influences affecting price changes. For example, the belief was widely prevalent that the depression of the thirties was due to a deficiency in the supply of lawful money. Gold-dollar devaluation and partial silver remonetization were indicative of the efforts to restore prosperity by increasing the supply of money. But fundamentally it was not an inadequate supply of money that brought on the depression of the thirties. The depression was induced by too rapid a contraction of debts, in the form of bank deposits, until, paradoxically as it may sound, we did not have enough debts with which to pay debts. Actually the per capita money in circulation in the United States in 1933 was greater than in 1929. Our credit structure, however, had shrunk.

7-14. Compensated-gold-dollar Plan. *a. Chief Features.* This scheme proposes a return to a modified type of gold standard. It seeks to stabilize the buying power of the dollar defined in terms of varying quantities of gold contained in it. According to the plan, the legal weight of the gold dollar is not fixed, as under the traditional gold standard, but is altered from time to time to conform with changes of commodity prices, as shown by index numbers. In other words, the content of the gold dollar is to be changed directly with the movement of prices. When the accepted index number shows that prices are rising, *i.e.*, the value of the dollar is falling, the gold content of the dollar is to be increased, as a result of which the number of dollars in a given quantity of gold bullion will become less. As prices go down, *i.e.*, as the value of the dollar rises, the gold content of the dollar is to be decreased, and the number of dollars (M in the equation of exchange) is thereby increased. This scheme, known as "the compensated-

[1] See pp. 157*ff*.

dollar" plan, has commonly been associated with the name of its sponsor, the late Prof. Irving Fisher. It is sometimes also referred to as the "commodity-dollar" proposal.

The plan of changing the weight of the gold dollar to conform to changes in price levels is predicated on the complete withdrawal of gold coin from circulation and the substitution of gold certificates. These gold certificates would represent a claim on the gold deposited in the Treasury of the United States, but the quantity of gold received for a gold certificate by those who converted their certificates into gold would be heavier or lighter, according as prices were high or low. The quantity of dollars that additional gold represented would depend on the index number at the time.

Gold certificates would always circulate in place of gold, and individuals who demanded actual gold for them would get varying weights of the metal, depending upon variations in the index number. The general public receiving and paying paper dollars would hardly be aware of the changes in the gold content of their money. Nevertheless, they would be benefited by constancy in the value of the dollar, *i.e.*, by the elimination of serious changes in the general price level.

b. Attempted Application. The monetary changes instituted by the Democratic administration in 1933–1934 were, in part, predicated upon the theory of the compensated dollar. The President was authorized to devalue the gold dollar to 50 per cent of its former value, *i.e.*, to raise the price of gold from $20.67 per ounce to $41.34 per ounce. Within these limits he could establish its value by executive order. All monetary gold was withdrawn from circulation and taken over by the Secretary of the Treasury. Gold certificates were made convertible, at the discretion of the Secretary of the Treasury, into gold bullion and not into gold coin. But the purpose of this gold-dollar devaluation, authorized by Congress in 1933, was not to stabilize the then existing level of prices but rather first to raise it before stabilization. On the other hand, the compensated dollar has been advocated as a device to maintain price stability at a particular level.

To prevent the speculative purchase or sale of gold, in anticipation of a change in the gold content of the dollar, the government could constantly keep its buying price for gold somewhat below its selling price. Thus if a speculator wanted to make a profit on the purchase of gold, he would have to hold it until the weight of the dollar had been reduced, *i.e.*, the dollar price of gold raised by more than the difference between the government's gold-selling and gold-buying prices. Otherwise he would have no chance of making a speculative profit on such transactions.

c. Criticism of Plan. Critics of the compensated gold dollar have expressed serious doubts as to its effectiveness in stabilizing the purchasing power of the dollar. They contend that a reduction of the gold content of the nominal dollar would not have any immediate effect on the general

price level. Even if the level of prices were to rise, there is no reason to believe that the number of gold certificates in circulation would be diminished, unless they were actually presented for gold, either for gold export or for use in industry.

But a rise in the general price level in the United States does not necessarily mean an exportation of gold in settlement of adverse trade balances, unless the prices of those commodities that enter into export have actually risen and thus tend to diminish our exports. Moreover, our international creditor status might prevent an outflow of gold, even in the face of a substantial rise in the prices of our exportable commodities. Nor is it likely that a sudden increase in the purchase of gold to be used in the arts of production would be stimulated by a rise in the level of prices.

Over a short period of time the compensated dollar would probably not be effective as a means of stabilizing the purchasing power of the dollar, but it might do so in the long run when credit currency has been expanded to the limit of rigid legal-reserve requirements. The possibility of increasing the number of gold dollars by decreasing the amount of gold in a dollar would tend to counteract possible deficiencies in gold production and a long-time downward trend in prices. Underlying the "compensated-dollar" proposal is the assumption that the postwar monetary system of the United States will be reestablished on some type of gold standard.

7–15. Neutral-money Proposal. According to this proposal, the aim of monetary policy is not to stabilize the level of prices, as is proposed in the compensated dollar. The objective of monetary policy is rather one of complete money neutrality. The quantity of money is to be kept constant (and thus be "neutral" with reference to economic activity), not interfering with economic processes in any way.

Behind the neutral-money proposal lies the assumption that economic disturbances in our economy, leading to recurring periods of inflation and deflation of prices, have their origin in changes in the quantity of money. If therefore the supply of money were kept constant, it is argued, these periodic disturbances would be removed, and business would progress more smoothly than in the past.

The advocates of the neutral-money proposal recognize that if the supply of money were to be stabilized, adjustments in the quantity of currency would have to be made for changes in the velocity of circulation. A further possible adjustment in the quantity of money might also have to be made under the neutral-money plan to allow for integration in industry, which would decrease the volume of T in the equation of exchange. If this were not done, there would be a tendency for prices to show an inflationary rise.

The major objection to the neutral-money proposal is that it is rather unrealistic. In the face of continuous technical progress and increasing

labor productivity, the resultant larger supply of salable goods matched against a constant quantity of money would require a continuous lowering of prices. Labor would have to reap the benefits of increased man-hour output in the form of lower prices of products rather than by higher money wages. Moreover, active competition among producers would have to exist in markets to bring down prices if market gluts were to be avoided. Both the attitude of labor and the existence of imperfect and monopolistic competition in our economy seem to preclude the possibility of adopting the neutral-money proposal, in spite of any theoretical advantages it may have over various plans to stabilize the level of prices. Nevertheless, a downward movement in prices with increasing productivity in our economy would diffuse the benefits of technological progress among all classes in the community more widely than a stable price level and rising money wages with greater labor efficiency.

7–16. Inconvertible Paper Money or Managed Currency. *a. Nature and Advantages.* Inconvertible paper money has been called "political money," "governmental money," or "fiat money" because it exists by virtue of the political authority issuing it. Its monetary value is not derived from a commodity of general serviceability, such as gold. It circulates freely as money because the government makes it legal tender, *i.e.*, it must be accepted by creditors in payment of debts, and because people have confidence in their government. Inconvertible paper money is in the nature of a governmental loan forced on the people. It is the government's promise to pay the face value of the paper money. When people have become habituated to the use of a paper medium of exchange, it is usually not difficult to make pieces of paper serve as money by a mere government decree. This has been amply illustrated in most countries during the past two decades. Where such paper money is made full legal tender for debts and is receivable at its face value for all public dues, it will normally perform all monetary functions as well as metallic money.

As previously pointed out, as long as the issue of such an inconvertible paper currency can be managed effectively, and people have faith in it and so are willing to accept it, fiat money can undoubtedly perform the monetary functions performed by metallic currency. In the long run, an inconvertible paper currency may thus be employed either to stabilize the level of prices by regulating the supply of fiat money in accordance with changes in the accepted index number or to stabilize the supply of money. Central bank control of the discount rate and open-market operations, explained in the following chapter, would be the chief means of currency management seeking to attain the established objective.

b. Objections to Fiat Money. Experience has amply demonstrated that few governments have been able adequately to manage the issue of an inconvertible paper currency. Advancing prices, resulting from an over-

issue of money, will usually stimulate business activity and spell prosperity in the minds of most people. A government that contracts the quantity of its circulating medium in order to bring about a reduction of prices soon finds itself unpopular. The expansion of the supply of lawful money in the United States, made possible by the various monetary changes of 1933–1934, including gold-dollar devaluation and partial silver remonetization, laid the foundation for expansion of credit currency incidental to financing the requirements of waging total war and threatened a pronounced inflation of the general level of prices at the close of the war, which soon became a reality in the immediate postwar period.

Most people have only vague notions of what money is, what are its functions, how it affects prosperity. Their instinctive attitude is almost always that of welcoming an increase in the money supply. Especially during and after periods of rising prices, the panacea of ever-plentiful money has many ardent advocates.[1]

There is always the danger that governments, with absolute control over the issue of money, will follow the line of least resistance in the issue of money. Taxes are never popular, and if a government can reduce direct taxes by issuing paper currency, this may be a far easier and more convenient method to obtain funds than by levying direct taxes. If the obligations thus created by the government cannot be met out of taxes, new obligations in the form of additional currency issues may be created. The process of currency inflation develops, money depreciates in value, prices rise accordingly, and with the rise in prices all the consequent effects upon various economic classes are experienced.

The danger of an overissue of inconvertible paper money on the part of governments is the fundamental objection to political money. Unless the issue of such currency can be controlled with a view to maintaining reasonable stability of the level of prices, it will prove a very hazardous substitute for a commodity-standard currency. To substitute a money depending for its acceptability as a medium of exchange upon governmental fiat, rather than on natural scarcity, reflecting production costs, is placing enormous powers in the hands of a government.

c. Conclusions. The frequent abuse of the power of governments to issue money in the past, however, should not prevent our giving serious consideration to such a plan for the future, in view of the possible shortage in monetary-gold production to sustain the current price level and the general change in monetary habits tending toward a constantly greater use of credit currency. The traditional gold standard has not proved a sound standard of value, for, as previously noted, the purchasing power of money based on gold has fluctuated violently over a period of time.

[1] Taussig, F. W., "Principles of Economics," vol. I, p. 309, The Macmillan Company, New York, 1911.

Either a compensated dollar, if a metallic currency base is to be maintained, or an inconvertible paper currency, controlled by a governmental bank of issue, offers a possible solution to the problem of instability in the purchasing power of money. Both suggested solutions have their distinct drawbacks, and will continue to be controversial issues in the future as they have been in the past.

7–17. Multiple or Tabular Standard of Deferred Payment. A further proposal for monetary reform, intended to stabilize the purchasing power of money over a period of time, would eliminate gold coin as the standard of deferred payments. Rapid changes in price levels, such as have been experienced in the past century, result in gross injustices between debtors and creditors. The multiple or tabular standard of deferred payments has been suggested as a remedy for these injustices.

a. Nature of Plan. This proposal is briefly as follows: Debtors shall be required to pay creditors an amount of control over commodities equal to the amount they have borrowed. In order to determine this amount, accurate index numbers must be prepared to indicate from time to time the changes in the price level. The amount of money to be repaid by the debtor will be determined by the index number changes.

For example, if the level of prices of the tabulated commodities has advanced 10 per cent between the time of making a loan and its repayment, 10 per cent more in money is paid by the debtor to the creditor. The payment of this larger sum will give the creditor as much of real buying power as he loaned. On the other hand, if the level of prices fell 10 per cent between the time of making a loan and its repayment, the debtor would pay back only 90 per cent of the money borrowed. Interest payments would be adjusted in like manner.

Thus, a single-commodity money would no longer be the standard of deferred payment, for the index number of a tabulated group of commodities would take its place.

b. Disadvantages. Certain objections may be raised to the policy of substituting a multiple for a single standard of deferred payments. In the first place, there is much uncertainty about the best way to compute index numbers. What weight shall be given to different commodities included in the index? Shall wholesale or retail prices be taken? How shall actual changes in prices be recorded? These are only a few of the many problems arising in connection with the preparation of index numbers.

Furthermore, the multiple standard injects a new element of uncertainty into credit transactions. The debtor would not know how much money he had to repay when his debt fell due. To be sure, there is an element of uncertainty in present credit transactions, owing to price fluctuations, but a multiple standard of deferred payment would not eliminate this and would merely introduce a new type of uncertainty.

c. Proposed Application to Federal Debt. The suggestion has been made that a part of the large Federal debt be converted into a multiple standard obligation, assuring creditors at maturity repayment in accordance with a stipulated official price index. If such a "stable money" bond were available, it would undoubtedly be sought by many investors who are looking for some assurance of stable buying power of their investment. They would be repaid the face value of the bond at maturity, plus or minus a number of dollars to "compensate" for change in the accepted index number, as compared with the time of issue.

But it would no doubt be far more desirable to strive for some element of price stabilization than to establish debtor-creditor relationships on an implied unstable level of prices. Postwar governmental and fiscal policy is avowedly striving to achieve and maintain a stable level of prices. Time alone will tell whether it will be possible to manage the supply of and demand for currency so as to achieve the desired objectives within the framework of our capitalistic institutions.

Guide Questions on Text

1. What gives purchasing power to money?
2. Explain how the purchasing power of money may be measured.
3. Distinguish between a weighted and an unweighted index number.
4. The value relationship among all items in an index number may change without changing the value of money. Explain.
5. Which is correct: the value of the dollar does not change; or, the price of the dollar does not change? Why?
6. Summarize the effects of changes in the level of prices upon different classes of people.
7. What causes the value of money to change?
8. State the equation of exchange and explain the significance of each item in the equation.
9. The equation of exchange has been called a truism. Do you agree with this assertion? Why or why not?
10. How would the following affect the level of prices, other things remaining the same:
    - *a.* A large inflow of monetary gold?
    - *b.* Contraction of Federal reserve notes?
    - *c.* Accumulation of large bank balances by depositors?
    - *d.* Increase of reserve requirements of commercial banks?
    - *e.* Pronounced increase in labor efficiency?
11. Explain the difference between the classical interpretation and the modern interpretation of the effects of changes in the supply of money on the level of prices.
12. Distinguish between secular and cyclical price-level changes.
13. Explain and evaluate critically the compensated-gold-dollar proposal.
14. What is meant by "neutral money"? How would it operate?
15. What gives an inconvertible paper money its value?
16. Under what circumstances would an inconvertible paper money provide a satisfactory medium of exchange?

17. What are the objections to an inconvertible-paper-money standard?
18. Evaluate critically the proposal for a multiple standard of deferred payment.

Topics for Investigation

1. Critical survey of alternative price indices for price stabilization.
2. Inductive study of the relationship between circulation of currency and the physical volume of production over a period of years.
3. Price instability as an insurable risk.
4. Price stabilization versus economic stabilization.
5. Price stabilization versus money income stabilization.

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See also Selected References, Chap. VI.

CHAPTER VIII

OUR BANKING SYSTEM

8–1. Functions of Commercial Banks. Before considering some of the problems of our banking system, it is necessary to have an understanding of the nature and functions of banks in our economy. These functions have undergone many significant changes in recent years, which, in turn, have given rise to a variety of new banking problems that will have to be dealt with in our postwar economy. Their solution, one way or another, will depend very largely on the structure of our postwar banking system.

Basically, banks are institutions dealing in money and credit. It is customary to speak of commercial banks, dealing in short-term loans, and of investment banks, extending long-term credit. Traditionally the business of commercial banks has consisted of receiving deposits and making loans of short maturity.

a. Sources of Deposits. Bank deposits are derived from many sources. Individuals having personal bank accounts deposit their "cash" items, such as money, checks, drafts, and other credit instruments, for which they receive deposit credit on their passbooks. In accepting deposits, banks agree to repay them, in whole or in part, on demand, or, in case of time deposits, at or after a stipulated time.

In addition to personal accounts, commercial banks also receive deposits from business enterprises, which make extensive use of banking facilities. Furthermore, banks in important financial centers obtain a large volume of deposits from banks in smaller cities and rural districts. Again, many banks carry deposits of Federal, state, and local governments. During the Second World War, Federal government deposits in insured commercial banks exceeded 23 billion dollars.

Bank deposits are derived largely from loans and investments, which are earning assets of commercial banks and serve as collateral security for their deposit liabilities. When, for example, a customer obtains a loan from his bank, he will ordinarily make out a 30-, 60-, or 90-day promissory note to the credit of the bank for the full amount of the loan, after which he will receive credit on his passbook for the amount of the loan, less the service charge or discount that is deducted immediately by the bank. In this manner commercial banks create deposits out of loans, and so provide funds for their customers.

These bank funds, in the form of bank deposits, as previously noted, normally circulate as credit currency and enjoy wide acceptability in our exchange economy. They therefore serve as a convenient substitute for actual money as media of exchange. Most business transactions in the United States are carried on with the aid of deposit currency in the form of bank checks rather than bank notes.

b. Creation of Credit Currency. The criticism has at times been voiced that commercial banks, when they created deposit currency out of loans and discounts, usurped the constitutional power of Congress to coin money and regulate the value thereof. This assertion is somewhat misleading. Traditionally, commercial banks merely substitute bank credit in the form of deposit currency for personal or business credit, on the theory that normally people have more confidence in the promises of banks to pay than in individual promises. It is more the substitution of one type of credit for another than it is the substitution of credit for money.

But in the decade before the Second World War, and particularly during the war, commercial banks were creating deposits extensively against the security of United States government obligations, which they acquired as earning assets. The deposits thus created do not represent the substitution of bank credit for personal credit but rather a substitution of bank credit for public credit. The full significance of this change in the collateral security behind deposits created by commercial banks, particularly during our war economy, must be grasped to appreciate the import of certain proposals for banking reforms, to be analyzed later.

Commercial banks do not create the demand for bank credit but respond to the demand. Basically, banks merely convert noncirculating credit or illiquid assets, whether represented by private promissory notes or government bonds, into circulating credit in the form of deposit currency and bank notes.

c. Bank Loans and Investments. Business loans made by commercial banks to business concerns are ordinarily short-term loans, intended primarily to furnish industry with working capital, which may be employed to purchase industrial materials and to meet various operating expenses. They are either unsecured loans or personal notes (one-name paper) or loans on endorsed notes (two-name paper). Moreover, loans may be secured by collateral, in the form of either stocks or bonds, warehouse receipts, mortgages, or other types of securities. Again, they may be either call loans, payable at any time at the will of either borrower or lender, or time loans, payable within a stipulated period of time.

The relative importance of private business loans by commercial banks in the asset portfolios of banks declined significantly in the decade before our entry into the Second World War and particularly during the war. In 1921 loans by commercial banks to private business interests were more

than three-fourths of their earning assets, and in 1929 they still represented 72 per cent of such assets. But by the end of the Second World War, in August, 1945, aggregate bank loans to private interests amounted to only about one-fifth of their earning assets, and less than half of these were strictly short-term commercial loans. In the early postwar years, however, business loans from banks again expanded, primarily to finance working capital requirements in this reconversion period. By the end of 1947 they approximated 32 per cent of the total loans and investments of all commercial banks.

d. Importance of Governmental Obligations as Earning Assets. Since the early thirties commercial banks have aided increasingly in financing Federal government deficits. While in June, 1929, all commercial banks of the country had only 10 per cent of their earning assets in obligations of the United States government, such holdings rose to 25 per cent in June, 1933, 43 per cent in December, 1941, and by 1945 had risen to nearly three-fourths of the total earning assets of all commercial banks of the country. The war emergency thus accentuated the prewar trend toward the growing importance of investments in government obligations among the earning assets of commercial banks. The rapid growth of commercial bank deposits during the war was due primarily to the increasing acquisition of United States government securities by the banks of the country.

The magnified importance of government obligations in the investment portfolios of banks has tied the structure of deposits more and more to the Federal debt, and correspondingly less and less to private loans and discounts. Short-term commercial loans, because of their very nature, have come to be regarded as highly liquid earning assets of commercial banks. Accommodation loans to private business interests to help meet working capital requirements form an excellent secondary reserve, giving reasonable assurance that banks will be able to meet the normal demands of depositors for cash at all times.

But government obligations are not self-liquidating in the ordinary course of business, as are commercial loans. Nor do they expand and contract with expansion and contraction of production of marketable goods. Their liquidity depends largely on their shiftability to other banks or investors in order to obtain cash without undue loss in face value. It will be shown subsequently how such shiftability of investments is provided by our banking system and what are the requisites for its continued effective operation.

e. Solvency and Liquidity. The security behind the deposit liabilities of a bank consists not merely of loans and investments but also of the personal liability of stockholders (in the case of national banks, and of some state banks, to the extent of the face value of their stock), the bank's deposits of its funds in other banks, the bank's stock of money, and finally its

tangible property (buildings, etc.). All these represent the assets or resources of a bank.

Although these bank assets may have a nominal face value far in excess of deposit liabilities, they do not suffice to maintain the solvency of a bank unless they can readily be converted into cash. Demand deposits are subject to withdrawal in cash by depositors at any time during business hours. If a depositor wants to withdraw his deposits in cash, the bank must be in a position to meet his demand. To do this, it must keep enough ready cash on hand or be able to obtain sufficient cash to meet all demands made by depositors for actual money.

f. Bank Reserves. A bank's reserves against deposits consist of the amount of cash and other asset items easily convertible into cash that it has available to meet demands for cash payments. The amount of such reserves is usually expressed as a certain percentage of the deposits, which varies in different commercial banks from as low as 5 per cent or less to 25 per cent or more. These reserves against deposit liabilities may be held in the bank's own vaults; or, as will be pointed out later, they may be deposited in other banks.

If it were assumed that all depositors would demand their deposits in cash at one and the same time without the bank's knowledge of when this might happen, the bank would have to have dollar for dollar in reserve at all times to meet such possible depositors' demands. But normally this does not happen, for while some depositors withdraw funds, others add to their deposits, and thus banks are able to incur liabilities to depositors far in excess of their actual cash reserves. This is the basic principle of fractional reserves, on which our commercial banking system operates.

g. Bank Notes. While in the past bank notes have been issued from time to time by commercial banks to provide a convenient medium of exchange, such notes are gradually disappearing as a circulating medium in our economy. For example, the national banks of the United States made extensive use of the privilege of bank-note issue prior to 1935. But since then, as previously indicated, the United States government has been retiring its outstanding bonds to which national-bank-note-circulation privileges were attached. This has meant a corresponding withdrawal from circulation of outstanding national bank notes, and the substitution of Federal reserve notes in their stead. State banks have not issued circulating notes since 1865, but confine their activities largely to making loans and receiving deposits.

8–2. Functions of Savings and Investment Banks. Savings banks are intermediary institutions between commercial and investment banks. They accept deposits, as do commercial banks, but allow the withdrawal of deposits only after a period of time subsequent to giving notice of withdrawal by the depositor. Savings deposits are time deposits and are com-

monly invested by savings banks in long-term investments. Savings banks thus aid in accumulating funds for investment in fixed capital.

Investment banks are financial institutions, likewise organized to aid in providing industry with fixed capital. They perform this function by financing the purchase and sale of securities, by organizing underwriting syndicates to facilitate the marketing of long-term investments, and, in general, by acting as functional middlemen between investors and investment opportunities. But in performing their function, they do not accept deposits, as do savings banks. Investment bankers are essentially marketers of securities rather than bankers in the ordinary sense of the word. With the aid of investment bankers, funds are obtained for industries and governmental agencies through long-term loans.

When an investment-banking syndicate has underwritten an issue of industrial securities, it will often pledge them, in whole or in part, as collateral for a short-time loan from a commercial bank. Funds thus borrowed are then advanced to the enterprise whose security issue has been underwritten. They are commonly spent to finance the acquisition of fixed assets in the form of plant extensions, betterments, etc. In this manner the commercial-bank loan is employed to provide industry with fixed rather than with working capital. When the securities are sold subsequently by the underwriting syndicate to investors, the proceeds are applied to the repayment of the commercial-bank loan, and the collateral is withdrawn. Therefore, the deposits of commercial banks may also aid in the development of the fixed assets of industrial enterprise, and not serve merely as sources of working capital. In spite of their interrelationship, however, the functions of commercial and investment banks may be fairly well differentiated.

8–3. National Banking System. *a. Establishment.* A brief history of the development of our commercial banking system will indicate its evolutionary nature and show how it has been modified from time to time to meet changing conditions in our economy. The national banking system grew largely out of the financial needs of the Union government during the Civil War. The Act of 1863, authorizing the chartering of national banks, revised in many respects in 1864 and notably modified by the Federal Reserve Act of 1913, is still the basis of our national banking system.

At the outbreak of the Civil War, the circulating media of the United States consisted of metallic currency and state bank notes, issued by some 1,600 banks operating under state laws. As a rule these state bank notes had only local circulation and, in some instances, were nearly worthless. In order to provide a sound uniform national currency, as well as to find a market for United States bonds, the sale of which was of vital importance for the prosecution of the Civil War, the national banking system was established.

The Act of 1863 provided that banks taking out a national charter must buy registered government bonds to an amount not less than $30,000 nor less than one-third of the paid-in capital stock and deposit them with the Treasurer of the United States; against them, as previously noted, they could issue their circulating bank notes. National bank notes issued against government bonds ultimately rested on the credit of the government instead of on the credit of the issuing bank. They were in the nature of credit currency, for they were secured by the government's promise to pay, dollar for dollar, by virtue of the security in government bonds. They were secured, in addition, by a 5 per cent redemption fund in lawful money, by a first lien upon the assets of the issuing bank, and by the personal liability of the stockholders of the national bank which issued them.

b. Functions and Reserve Requirements. National banks perform the general functions of commercial and savings banks, namely, to make loans and investments and to accept demand and time deposits. In order to ensure prompt payment of deposit liabilities, national banks were required under the Act of 1863 to keep a reserve of lawful money (including gold and silver coin, gold and silver certificates, and United States notes) against their deposits.

Banking centers were divided into three classes, central-reserve cities, reserve cities, and nonreserve centers, commonly known as "country banks." Banks in central-reserve cities had to keep in their own vaults a 25 per cent "lawful money" reserve against deposits. Reserve-city banks also were required to maintain a 25 per cent reserve, one-half or less of which could be kept on deposit in central-reserve cities. Country banks had to keep a 15 per cent reserve against deposits, three-fifths or less of which could be deposited with central-reserve or reserve-city banks. In other words, country banks had to keep an actual cash reserve of 6 per cent in their own vaults, and reserve-city banks 12½ per cent. On the other hand, central-reserve-city banks had to keep a reserve against deposits of at least 25 per cent of lawful money.

c. Defects of the National Banking System Prior to 1913. The foregoing brief survey of the legally prescribed powers and duties of national banks serves as a background to an analysis of certain outstanding defects of our national banking system prior to 1913. They were, primarily, (1) lack of coordination and of centralized control (2) inelasticity of credit, (3) pyramiding of reserves.

Strictly speaking, the national banking system was formerly a loose association. One bank could not legally establish branches in another city. The banks in the different cities were so many individual units, each looking after its own interests. Clearinghouse associations for the purpose of collecting and canceling interbank payments were established in the larger cities only by voluntary agreements among member banks. They

engendered some cooperation, but were unable to prevent suspension of cash payments when an emergency arose.

As a means of self-protection in times of financial stress, each bank withdrew its deposits from other banks. This decreased the possibility of extending further loans, particularly on the part of central-reserve banks, at the very time when extension of credit was most necessary. The maintenance of the "Independent Treasury" of the United States added to the difficulties of the national banks by causing irregular withdrawals of money from circulation into the treasury, when obligations to the government had to be paid. Bank reserves were depleted when large governmental revenues flowed into the treasury, and these funds did not come into circulation again until some time later.

Banks, moreover, could not expand their lending power readily to meet business needs. The inelasticity of credit resulted not only from the rigid legal-reserve requirements against deposits (25 per cent and 15 per cent), but also from inability of banks to rediscount commercial paper. There was no general rediscounting agency under the national banking system prior to 1913. Reserves against deposits in national banks could not legally be employed to extend further credit at the very time when these funds were sorely needed.

Moreover, the national banking system prior to 1913 was defective in that it permitted the pyramiding of bank reserves in large financial centers. No bank normally wants to keep any more money idle in its own vaults than is absolutely necessary. Since country banks under the National Banking Act were permitted to deposit three-fifths of their reserves with central-reserve and reserve-city banks, and the reserve-city banks, in turn, could deposit one-half of their lawful reserves with central-reserve-city banks, the tendency was for idle funds to drift to the large banking centers, primarily New York, where they ordinarily would yield 2 per cent interest and yet be subject to call at any time. Thus in 1912, 10 leading New York banks and trust companies had 15,483 bank depositors. In order to keep their deposits as liquid as possible, central-reserve-city banks preferred to invest their surplus funds in call loans, made chiefly to stockbrokers against the security of listed stocks and bonds.

In times of financial stress country banks would withdraw their deposits from reserve-city banks, and these, in turn, would demand their deposits from the central-reserve-city banks. In order to meet their obligations, central-reserve banks were forced to call their loans. Hence, prices on the stock market collapsed under a wave of wild selling in order to realize funds. In the absence of an adequate source of credit currency or a rediscounting agency to tide over such periods of financial distress, suspension of payments of demand obligations on the part of many banks all over the country was inevitable. Every bank sought to build up its

own reserves in order to remain solvent, while the further extension of bank credit was practically suspended for the time being.

In the absence of any powerful central or regional banks, mobilizing at points of weakness, thus upholding the whole structure of credit and giving confidence and support to all sound banks, the accumulated reserves in New York and other reserve cities were torn down and scattered among thousands of individual banks, each scrambling for all the gold it could get. Under every great strain this individual reserve system has completely broken down.

8–4. Federal Reserve System. *a. Events Leading to Adoption.* After the severe financial panic of 1907, definite steps were taken by Congress to remedy the glaring defects of the national banking system. The Aldrich-Vreeland Act of 1908 created the National Monetary Commission, composed of members of the Senate and the House of Representatives, charged with making an investigation into the monetary and banking systems of the leading commercial countries of the world. Their painstaking report, representing studies, investigations, and collections of material over a period of 4 years and filling nearly 50 volumes, constitutes the most exhaustive study of the subject ever made.

With its report, the Commission also submitted a constructive proposal, known as the "Aldrich Plan," named after the chairman of the Commission. It provided for a National Reserve Association, a bankers' bank, in an effort to remedy the defects of the national banking system just described.

Because of the impending presidential election in 1912, Congress took no action on the Aldrich Plan. But with the advent of the Wilson administration and a Democratic majority in Congress, the matter of banking reform became one of the first items on the program of the special session of Congress that opened the day after inauguration.

A new banking plan, known as the Owen-Glass Bill, was drawn up. It embodied many of the features of the Aldrich Plan, but substituted a Federal Reserve System for a central bank. After many weeks of active discussion inside and outside the halls of Congress and after numerous amendments in details, the bill was finally enacted into law, Dec. 23, 1913, as the Federal Reserve Act of 1913.

b. Organization of Federal Reserve Banks. The Federal Reserve Act provided for the division of the country into from 8 to 12 districts with a Federal reserve bank in each district.[1]

The capital stock of each Federal reserve bank was to be not less than 4 million dollars. National banks were required, and state banks and

[1] There are now 12 Federal reserve districts. The centers of these districts are: (1) Boston, (2) New York, (3) Philadelphia, (4) Cleveland, (5) Richmond, (6) Atlanta, (7) Chicago, (8) St. Louis, (9) Minneapolis, (10) Kansas City, (11) Dallas, and (12) San Francisco.

trust companies were permitted, to subscribe to the capital stock of the Federal reserve bank in their district and thus to become members of the Federal Reserve System. The amount of such subscriptions was equal to 6 per cent of their own capital and surplus. One-half of this amount had to be paid in three equal installments, and the other half remained subject to call.

Each Federal reserve bank is supervised by a board of nine directors. Three of these directors are appointed by the Board of Governors of the Federal Reserve System, formerly the Federal Reserve Board. The remaining six are chosen by member banks. Of these six, three represent member banks, and three "must be actively engaged in their district in commerce, agriculture, or some other industrial pursuit."

The president of the board of directors of a Federal reserve bank is selected by the board of directors of the bank, subject to the approval of the Board of Governors of the Federal Reserve System. He is known as the Federal reserve agent. Moreover, the Board of Governors also designates one of the directors it has appointed as chairman of the board. He performs administrative duties similar to those of the president of a bank.

c. Federal Control through Board of Governors. Although privately owned and managed, the Federal reserve banks are under strict governmental control. Supervisory powers were formerly vested in the Federal Reserve Board, but this board was renamed, reorganized, and its powers further expanded under the Banking Act of 1935. The name of the board was changed to the Board of Governors of the Federal Reserve System. It is now composed of seven members, appointed by the President of the United States, with the advice and consent of the Senate. One of the members of this board is designated chairman by the President, and another vice chairman. Board members hold office for a period of 14 years, unless removed for cause, while the chairman and vice chairman are appointed for a period of 4 years. Thus the period of office of the Board of Governors extends over several administrations, while that of the two major officers of the board may be terminated with each administration. Such an arrangement tends to minimize the possibility of making the board a political agency.

d. Powers of the Board of Governors. Broad, sweeping powers have been vested in the Board of Governors. They have expanded from time to time since the creation of the Federal Reserve System in 1913; they were enlarged particularly under the Banking Act of 1935. Among others, they embrace the powers (1) to supervise generally all Federal reserve banks; (2) to appoint three directors of each Federal reserve bank and to suspend any of its officers or directors; (3) to rearrange Federal reserve districts; (4) to examine accounts and affairs of reserve banks and member banks

and to require such statements and reports as are necessary; (5) to determine classes of commercial paper eligible for rediscount and to review and determine rediscount rates charged by Federal reserve banks; (6) to require the reserve bank of one district to rediscount paper held by another reserve bank; (7) to suspend reserve requirements of reserve banks; (8) to give consent to reserve banks to establish foreign branches and agencies; (9) to alter, within limits, reserve requirements of member banks (Banking Act of 1935); (10) to supervise, through the Open-market Committee, the open-market operations of member banks. This general summary of powers of the Board of Governors of the Federal Reserve System indicates the extent to which the board supervises, controls, and directs the activities of the Federal Reserve System.

e. Federal Advisory Council. The Federal Reserve Act of 1913 also created the Federal Advisory Council to advise and consult with the Board of Governors and to keep it in touch with economic and financial conditions throughout the country. The council is composed of one representative of each Federal reserve bank, elected annually by its board of directors from among the bankers in the district. This council meets in Washington at least four times each year to confer with the Board of Governors and make recommendations on Federal reserve policy.

f. Functions and Funds of Federal Reserve Banks. Federal reserve banks have been called "bankers' banks" since they deal primarily with member banks and with the government and only to a limited extent with the general public. Their chief functions were set forth in the preamble to the Federal Reserve Act of 1913 as follows:

> . . . to furnish an elastic currency, to afford means of rediscounting commercial paper, to establish a more effective supervision of banking in the United States, and for other purposes.

In order to provide an elastic currency, for peacetime business as well as for war emergency, the Federal reserve banks must be able to expand and contract the volume of circulating medium to meet currency requirements. To expand credit currency, they must have control over funds that they can lend to member banks, as well as to the Government when required.

Federal reserve banks obtain their funds from four main sources: (1) capital stock subscriptions of member banks, (2) deposits of member banks, (3) government deposits, and (4) surplus. These four sources of funds form the basis for the extension of deposit credit on the part of Federal reserve banks by making loans and investments.

Member banks not only provide Federal reserve banks with funds by their stock subscriptions (one-half of which have been paid in to date), but they are also required to keep reserves against their own demand and

time deposits with the Federal reserve banks in their respective districts. Before 1935, central-reserve-city banks (New York and Chicago) had to have reserves equal to not less than 13 per cent, reserve-city banks not less than 10 per cent, and other banks not less than 7 per cent of their demand-deposit liabilities. These reserves of member banks, as well as a 3 per cent reserve against time deposits, were deposit balances held by the Federal reserve banks.

Under the Banking Act of 1935, the Board of Governors of the Federal Reserve System, upon an affirmative vote of not less than four of its members, may change the reserve requirements against demand and time deposits of member banks. Such reserves, however, may not be reduced below those required by law on the date of enactment of the Banking Act of 1935, but they may be doubled or increased within that limit.

In August, 1936, the board raised the reserve requirements of country, city, and central-city member banks, respectively, by 50 per cent in order to absorb a portion of the excess reserves of member banks. The power conferred upon the board was to serve as a means of controlling injurious credit expansion or contraction. But the unprecedented inflow of gold into the United States prior to and shortly after the outbreak of the Second World War, resulted in a rapid accumulation of excess reserves in our banking system. In January, 1941, excess reserves, *i.e.*, reserves above legal minimum requirements held by member banks, totaled nearly 7 billion dollars.

With a view to reducing these excess reserves and to curbing the wartime likelihood of too rapid credit expansion by member banks, the Board of Governors in November, 1941, again raised reserves requirements of member banks to double the statutory minima. This was the limit permitted by the Banking Act of 1935, namely, 26, 20, and 14 per cent respectively for central-city, city, and country banks.

The amount of cash each member bank keeps in its own vault is left to the discretion of the individual bank. The reserve balances of member banks with Federal reserve banks can be built up either by actual cash deposits or by rediscounting eligible commercial paper, *i.e.*, by making loans from Federal reserve banks.

Federal reserve banks obtain funds from governmental deposits. The Federal Reserve Act of 1913 provides that monies held in the general fund of the Treasury, with certain exceptions, may,

> . . . upon the direction of the Secretary of the Treasury, be deposited in the Federal reserve banks, which banks, when required by the Secretary of the Treasury, shall act as fiscal agents of the United States.[1]

Surplus is accumulated out of earnings of Federal reserve banks. After paying a dividend of not more than 6 per cent on member banks' paid-in

[1] Sec. 15.

subscriptions to the capital stock of Federal reserve banks, all excess earnings are carried to surplus account.

g. Reserves of Federal Reserve Banks. The primary obligations of our Federal banking system are to its depositors (the member banks) and to its note holders (the general public using paper money). Prior to 1945 Federal reserve banks were required to maintain lawful-money reserves equal to 35 per cent against deposits and 40 per cent in gold (since 1934, in gold certificates) against outstanding Federal reserve notes. These reserve requirements were not rigid but might be suspended by the Board of Governors of the Federal Reserve System for definite periods of time, on payment by the Federal reserve banks of a graduated rate of taxes on increasing deficiencies. This graduated tax on deficiencies in reserves was suspended during the national emergency in 1933–1934, and for the time being no automatic increase in rates existed as a possible check on credit-currency expansion.

The abnormal demand for additional currency incidental to financing war requirements, beginning with the intensive rearmament program in 1940, gradually reduced the reserves of Federal reserve banks to near the basic legal minimum of 35 and 40 per cent, respectively. To impose a tax on a deficiency in reserves under such circumstances would have added to the cost of government borrowing from Federal reserve banks.

As the reserve ratio in 1945 approached 40 per cent, which had come to be accepted as the minimum below which the ratio should not be permitted to fall, a law was passed by Congress in June, 1945, permitting a reduction of the combined reserve ratio against Federal reserve notes and deposits to 25 per cent. By this act Federal reserve banks were provided with approximately 5.5 billion dollars of additional reserve funds. Furthermore, it made permanent the authority of Federal reserve banks to use United States government obligations as collateral for Federal reserve notes. Under the Federal Reserve Act of 1913, collateral was originally limited to rediscounted commercial paper.

h. Elasticity of Bank Currency. The Federal Reserve System has thus provided an elastic bank credit to meet normal peacetime requirements as well as abnormal wartime demands (1) by establishing a rediscounting agency for member banks, (2) by centralizing reserves of member banks in the Federal reserve banks, (3) by materially reducing member-bank reserve requirements against deposit liabilities as compared with reserves before 1913, and making them somewhat flexible under the Banking Act of 1935, and (4) by open-market operations (discussed below).

The Federal Reserve Act, as amended from time to time, has provided the necessary machinery for the contraction, as well as expansion, of deposit currency. The following forces are deflationary: (1) the pressure of high discount rates, (2) under normal conditions the progressive tax on in-

creasing deficiencies in the legal reserves against deposits, (3) the possible increase in member-bank reserve requirements if authorized by Congress, (4) the sale of Federal reserve holdings in the open market, and (5) further restrictions by Federal reserve banks on member-bank discounting. One or several of these influences would tend to discourage further borrowing and to induce borrowers to pay off their loans. Consequently the circulation of deposit currency would tend to contract, as a result of the contraction of Federal reserve credit.

i. Open-market Operations of Federal Reserve Banks. Anticipating that the rediscounting function of member banks might not keep all the funds of the Federal reserve banks actively employed, and believing that a further means was needed to regulate the extension of credit by Federal reserve and member banks, the Federal Reserve Act also provided for certain open-market transactions of the banks. By open-market operations of Federal reserve banks is meant their dealing at home and abroad in government securities and in state and municipal obligations maturing within 6 months, as well as in bankers' acceptances, bills of exchange arising out of commercial transactions, and gold coin and bullion.

These open-market operations of Federal reserve banks exercise a measure of control over the volume of commercial credit available for member banks. Federal reserve banks can take the initiative in exercising such control. For example, by purchasing United States securities in the open market, a Federal reserve bank pays with a cashier's check, which the seller of the investments ordinarily deposits in his bank. The bank, in turn, can use those additional funds either to reduce its indebtedness to the Federal reserve bank or to increase its funds deposited there as reserve, against which it may conceivably expand its own loans to customers and so increase their deposits. Thus the purchase of investments by a Federal reserve bank releases member-bank credit that is made available for further credit expansion.

On the other hand, when a Federal reserve bank sells securities in the open market, it ordinarily receives payment by check drawn on a member bank. This check is charged against the member bank's deposits with the Federal reserve bank, which thus reduces the member bank's legal reserves against its own deposits. To replenish these reserves, the member bank may either borrow from the reserve bank by rediscounting acceptable commercial paper, call some of its loans, or possibly sell its investments. Thus the sale of securities in the open market by Federal reserve banks tends to contract the available supply of member-bank credit.

j. Federal Open-market Committee. With a view to further centralizing control over open-market operations, the Banking Act of 1935 created a Federal Open-market Committee. This committee consists of the Board of Governors of the Federal Reserve System and five representatives of

the Federal reserve banks. It meets at least four times each year in Washington, upon call of the chairman of the Board of Governors. It controls the open-market operations of Federal reserve banks and adopts regulations relating to open-market transactions of such banks. The character of open-market operations is governed, in general, "with a view to accommodating commerce and business and with regard to their bearing upon the general credit situation of the country."[1] No Federal reserve bank may either engage or decline to engage in open-market operations, except under the direction of, and in accordance with, regulations adopted by the Open Market Committee.

8–5. Qualitative Control of Bank Credit. *a. Margin Requirements.* While quantitative control over member bank credit can be exercised through regulation of rediscounting operations and through open-market transactions, the use to which such bank credit may be put also is subject to Federal reserve control. The Board of Governors has been empowered to control the use of bank credit for speculation in securities, by changing margin requirements. Prior to 1946, speculators who bought securities on margin could borrow part of the purchase price from brokers in excess of their cash-down payment, or margin, giving the purchased securities as collateral for the loan. Brokers, in turn, might borrow the requisite funds to make the speculative loan from commercial banks. The smaller the margin of cash required by the speculator, the larger the amount that could be borrowed to pay for the securities bought, and vice versa.

Consequently, by raising margin requirements, the Board of Governors could curb the use of bank credit for speculation in securities. The Securities Exchange Act of 1934 empowered the Board to fix minimum margin requirements for dealings on the major security exchanges. Margin requirements were changed several times by the Board of Governors since 1934, with a view to controlling the use of bank credit for speculative purposes, until early in 1946, when they were raised to 100 per cent. That is, listed securities had to be purchased outright; they could not be bought with the aid of loans on the securities purchased. This action was designed to curb further expansion of the use of speculative credit, in view of the excessive supply of currency in circulation which was finding its way into the securities markets. But even a 100 per cent margin requirement was not able to halt the upward movement in stock prices in the immediate postwar period. Between April, 1945, and April, 1946, the market value of listed shares on the New York Stock Exchange rose from 61.5 billion dollars to 80.9 billion dollars, or by 31.5 per cent. Elimination of buying stocks on margin had not prevented direct borrowing on personal notes to purchase securities if individuals wanted to buy stocks with such bank loans instead of brokers' funds. But the speculative rise in security prices

[1] Banking Act of 1935, Sec. 205(c).

yielded to a substantial decline, even before the end of 1946. Consequently, these regulations were relaxed and margins of 75 per cent were permitted for the purchase of some stocks.

b. Installment Credit. A further type of qualitative credit control exercised by Federal reserve banks relates to installment finance. Installment or consumer credit had developed rapidly since the middle of the twenties, and at the time of our entry into the Second World War, the volume of such credit outstanding totaled 9.5 billion dollars. In our system of roundabout production a period of waiting is necessary between the inception and the completion of the productive process. The time when the produced good has yielded up its last bit of utility to the consumer is still further in the future. This waiting period, or "period of production," involves the extension of credit by someone, whether it be extended to the producer or to the consumers of the good. It makes little difference whether the waiting for the last bit of service yielded by a home is financed as consumer credit to the owner or user or as producer credit to the contractor or builder. The same holds true of financing the purchase of various other durable consumers' goods with consumer credit. The risks involved in the extension of such credit grow primarily out of a possible interruption of production with simultaneous unemployment and resultant loss of consumer power to buy goods and even to pay for those commodities already bought on time.

The expansion of installment credit by sellers, moreover, has essentially the same effect on consumer buying power as direct loans made by banks to consumers. If more new loans are made by sellers to finance the purchase of durable consumers' goods than old loans are repaid, the volume of installment credit outstanding will tend to increase. During the depression of the thirties it was desirable to increase the volume of such consumer credit with a view to stimulating production and employment, but this was not the case when we began our intensive conversion of industries to war goods production. In a period of expanded earnings (but also of restricted production of such durable consumers' goods as refrigerators, radios, household appliances, and automobiles) unrestricted consumer demand in the face of a curtailed supply of goods would have led to a rapid rise in prices.

In September, 1941, the Federal reserve banks began to impose restrictions on the continued use of installment credit. The initial regulation pertained only to certain articles interfering with defense production, but the restrictions were extended more and more during the war period, both by increasing minimum down payments (analogous to margins on stocks) and by reducing the maximum length of the payment period. As a result of these restrictions, despite increasing ability to pay installment debts out of swollen wartime incomes, the total consumer credit outstanding at

the close of the Second World War was only about 5.5 billion dollars, or 42.3 per cent less than at the time of our entry into the war. But after the close of the war, in August, 1945, consumer credit again expanded rapidly, reaching a total of 7.5 billion dollars in May, 1946, and over 13 billion dollars in December, 1947.

8–6. Lack of Uniformity in Commercial Banking in the United States. The development and operation of our commercial banking under governmental control through the Federal Reserve System have been traced in the preceding pages. Strictly speaking, our commercial banking system is not a system at all but rather an aggregation of units under a series of regulations.

The Federal Reserve System was organized to give some degree of governmental control over American banking. But the actions of the Federal Reserve Board (now Board of Governors) and the activities of Federal reserve banks were inadequate to prevent the financial cataclysm of 1929. This ineffectiveness was due, in part, to financial abnormalities growing out of the First World War, which will be discussed in the following chapter. But even more so, it can be traced to the lack of real centralization of authority over banking in the United States. Our banking system has had little organic growth; it developed from time to time to meet the exigencies of the day.

The national banking system originated from the fiscal needs of the Civil war. Before the Federal Reserve System had opportunity for normal peacetime development, it was confronted with the financial emergency of the First World War. The first banking experiences thus obtained by both the national banking system and the Federal Reserve System were war experiences, and not those arising out of normal peacetime commercial-banking activities.

The federal character of the American government also works against uniformity of regulation and centralization of control. State banks, chartered under the laws of 48 separate states, continue to function in the United States; they may or may not be under the supervision of the Federal Reserve System. On Dec. 31, 1943, there were 8,989 state commercial banks out of a total of 14,034 banks in the country. Only about 19 per cent of these state commercial banks were members of the Federal Reserve System. As their banking policies are subject to state regulation and supervision, there is no uniformity in the banking system of our nation. Nor is there continuity; a state bank may withdraw from membership in the Federal Reserve System if it is dissatisfied with the degree or type of control exercised over its banking policies by Federal reserve agencies.

But even nonmember banks are indirectly related to the Federal Reserve System. Their contact is established through their correspondent banks in various financial centers. Moreover, Federal reserve banks have

from time to time purchased acceptances of state banks and so provided them with Federal reserve funds. Thus, although nonmember state banks are not under direct control of the Federal Reserve System, they are indirectly influenced thereby and derive many benefits from such association without affiliation.

Central banking under the Federal Reserve System will continue to be limited in its effectiveness as long as thousands of commercial banks choose to remain state banks that are outside the direct supervision of that system. It will be a long time before the states will relinquish to Federal authority (if they ever do so) their right to regulate, as they see fit, commercial banking within their own borders. This seems especially true now that the benefits of Federal deposit insurance are extended to nonmember state banks meeting legal requirements, as well as to member banks.

In the following chapter banking policies of the United States under the Federal Reserve System between the two world wars and during the Second World War will be analyzed. Special consideration will be given to the many banking reforms growing out of the financial debacle following the stock-market crash of 1929 and to the role played by banks in financing the Second World War.

Guide Questions on Text

1. What functions are performed by commercial banks?
2. Explain the several sources of bank deposits.
3. Do commercial banks create buying power when they create deposits out of loans and discounts? Explain.
4. What is the difference, if any, between substitution of bank credit for personal credit and for public credit?
5. Explain the reasons for the significant changes in the earning assets of commercial banks since the depression of the thirties.
6. "Government obligations are not self-liquidating, as are commercial loans." Explain.
7. Explain what is meant by bank reserves.
8. Distinguish between bank notes and bank deposits.
9. Point out the essential differences between commercial banks, savings banks, and investment banks.
10. "The national banking system grew largely out of the financial difficulties of the Union government during the Civil War." Explain.
11. Point out the chief defects of the national banking system prior to 1913.
12. How was the Federal Reserve System designed to correct these defects?
13. Analyze the organization of the Federal Reserve System.
14. Summarize the powers vested in the Board of Governors of the Federal Reserve System.
15. Federal reserve banks have been called "bankers' banks." Explain.
16. Show how the Federal Reserve System provides an elastic credit currency.
17. Distinguish between open-market operations and the discounting functions of Federal reserve banks.

18. What operations of Federal reserve banks are inflationary, and what operations are deflationary? Why?

19. Explain the meaning of qualitative control of bank credit, and give two illustrations of such control.

20. What do you consider a major current problem of commercial banking in the United States? Why?

Topics for Investigation

1. Causes and effects of changing asset portfolios of commercial banks.
2. Strength and weakness of credit controls of the Federal Reserve System.
3. Public debt expansion and Federal reserve policy.
4. Economic objectives of bank credit control.
5. Similarities and differences between public credit and personal credit as basis of bank loans.

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See also Selected References, Chap. IX.

CHAPTER IX

BANKING PROBLEMS AND BANKING REFORMS

9–1. Changes in Commercial Banking Policies. It is necessary to review briefly the effects of business activities on commercial banking policies in the United States in order to understand the differences between the banking problems after the First World War, and those confronting our banking system at the close of the Second World War. The position of commercial banking in our economy has undergone many important changes during the past quarter of a century, changes that may be ascribed either directly or indirectly to the disruptive consequences of wars.

a. Increase of Bank Reserves and the Influx of Gold. With the precipitous decline of commodity prices in 1920 and the resultant business depression in 1921, excess bank reserves began to accumulate. Outstanding bank loans were being repaid, and the volume of new bank loans was decreasing. Loans and discounts of all banks in the United States and island possessions declined from 31.3 billion dollars on June 30, 1920, to 27.7 billion dollars on June 30, 1922, or by 12 per cent. On the other hand, reserve balances of member banks deposited in Federal reserve banks increased over a billion dollars, or by 34 per cent, during the same interval.

Member banks were able to decrease their loans, as well as to increase their deposits, at the Federal reserve banks with the foreign gold that was flowing into the country in payment of adverse trade balances. The influx of monetary gold into the United States, which had received its initial impetus during the First World War, continued intermittently for a decade after 1920. From 1921 to 1930, for example, the stock of monetary gold in the United States increased well over one billion dollars, amounting to 4.5 billion dollars on May 31, 1930.

It may be pointed out parenthetically that as a result of the revaluation of the huge stock of monetary gold in the United States in 1934, the dollar value of our gold holdings was raised to about 7.8 billion dollars. But this should not be interpreted as an actual increase in the stock of monetary gold in the country.

When business began to revive in 1922, American banks were in a position to meet the growing demands for funds to finance industrial activity without drawing heavily on Federal reserve credit.

That the banks of the country were able to finance the credit requirements of an enlarged volume of business and to meet an increase in the demand for currency

amounting to more than $500,000,000, without giving rise to a demand for additional Federal reserve bank credit, is explained by the fact that member banks met this demand by the use of funds made available by the continued inflow of gold.[1]

b. Prosperity without Rising Commodity Prices. American industry had apparently learned a lesson from post–First World War inflation of commodity prices and their subsequent collapse. Rather than seek speculative profits by accumulating large inventories to be held for advancing prices after the depression of 1920–1921, industry concentrated on new developments in business organization and policy. Hand-to-mouth buying, budgetary control, balanced inventories, managerial efficiency, wide distribution of products to spread overhead costs, waste elimination, and the like were familiar slogans of the "second industrial revolution" in the United States. They contributed to decreasing unit costs of production, and so increased the profitability in many branches of industry by lowering costs and increasing turnover.

The industrial activity of the twenties was, therefore, not featured by an inflated commodity-price level. Although the average wholesale-commodity-price index advanced slightly between 1921 and 1925, it declined in subsequent years, so that it was actually lower in 1929 than in 1921. If judged by the high degree of stability in wholesale prices, there was apparently no overexpansion of commercial-bank credit for industrial purposes in spite of the pronounced industrial activities of the twenties.

Business in general was prospering. Corporate earnings showed a decided upward trend between 1922 and 1929. Net income of all corporations, reported to the Federal government for income-tax purposes, was 83 per cent larger in 1929 than in 1922. But not all industries were prospering during this period. Conspicuous among the "sick" industries were textiles and coal, while agriculture seemed to be suffering from a chronic depression since the close of the First World War.

c. Dilemma of Federal Reserve Banks. Excess bank reserves and large holdings of monetary gold laid the groundwork for a wave of speculation, which was aided by the existence of abundant credit facilities. This speculative activity made itself noticeable late in 1925, first in real estate and later in securities. In consequence, Federal reserve banks were confronted with a peculiar dilemma. To raise rediscount rates with a view to curbing speculative use of commercial-bank credit might have had an adverse effect on legitimate business. Higher money rates, moreover, would have tended to encourage an inflow of foreign funds to take advantage of these higher rates and so to make difficult the maintenance of the gold standard, which the leading industrial and commercial countries had readopted in one form or another. On the other hand, if Federal reserve

[1] Federal Reserve Board, *Annual Report*, 1923, p. 2.

banks had kept rediscount rates relatively low, they would have encouraged further borrowing, indirectly to feed the flames of speculation. Funds normally utilized for working capital by industries could be lent on call against securities, while commercial loans for business purposes could be made against rediscountable commercial paper. The difficulties confronting Federal reserve banks were summarized in the following statement of the Federal Reserve Board:

> In determining upon credit policy, the Federal Reserve System is always under the necessity of balancing the advantages and disadvantages that are likely to follow a given course of action. Low money rates may have a favorable effect on domestic business, but at the same time may stimulate speculation in securities, commodities, or real estate. High money rates, on the other hand, may exert a moderating influence on speculation, but at the same time may result in a higher cost of credit to all lines of business, and thus be detrimental to commerce and industry; ultimately they may draw gold from abroad, which would tend to ease the domestic situation.[1]

9–2. New-era Philosophy. *a. Federal Reserve Policy.* The relatively stable commodity-price level after 1922 and the increasing industrial profits—due not to advancing prices (as common in the past) but rather to lower unit costs of production with large turnover—led many to believe that a new industrial era had been inaugurated in the United States since the industrial revival in 1922. This new-era gospel appealed to the imagination of the masses and released the speculative forces which culminated in the tragic stock-market collapse in the fall of 1929.

What then was the actual Federal reserve policy toward this wave of speculative activity? Late in 1927 the Federal reserve banks lowered their rediscount rates to 3½ per cent and expanded their purchases in the open market, apparently prompted by their desire to ease money conditions so as to aid European countries in reestablishing and maintaining their gold standards and encouraging foreign loans with which to buy American products.

The effect of this easy-credit policy upon speculation was unmistakable. Market prices of stocks continued to climb upward, financed largely with the borrowing of an apparently unlimited supply of bank credit. Brokers' loans reported by the New York Stock Exchange (mostly call loans) continued to grow from month to month until they reached the unprecedented total of almost 8.6 billion dollars in September, 1929.

Many corporations, moreover, taking advantage of favorable market conditions to issue large volumes of new securities, often in excess of their immediate capital requirements, used part of the proceeds to retire their funded debts, and thereby reduced their overhead or fixed charges. The

[1] Federal Reserve Board, *Annual Report*, 1928, p. 9.

purchasers of these securities, in turn, ordinarily borrowed a portion of the purchase price from their banks, giving the securities as collateral. Thus bank loans for commercial purposes declined relative to loans on corporate securities consisting largely of common stocks.

Attempts on the part of the Federal Reserve Bank of New York to curb excessive speculation by successively raising rediscount rates in 1928 from 3½ to 4 and 4½ per cent proved unsuccessful, particularly in the face of statements appearing from day to day in various publications (presumably made by authoritative persons) that brokers' loans were not excessive and that warnings of the Federal Reserve Board against overspeculation represented the remonstrances of a "mid-Victorian maiden aunt." It will continue to be a debatable question as to whether a more drastic rediscount and open-market policy in 1928 could have prevented the stock-market debacle in 1929.

b. Collapse of Stock Prices and Contraction of Credit. With the sudden crash in the stock market, in October, 1929, Federal reserve rates declined rapidly. Within half a year the Federal Reserve Bank of New York reduced its rediscount rate six successive times until it reached a low of 2½ per cent in June, 1930. Meanwhile, brokers' loans reported by the New York Stock Exchange declined to around 4.5 billion dollars or 48 per cent below the 1929 peak, while member-bank borrowings at Federal reserve banks decreased from a monthly average of nearly one billion dollars in the fall of 1929 to less than 25 million dollars, or but 2½ per cent of the 1929 high in April, 1930. This decrease in member-bank borrowings from the Federal reserve banks was made possible, in part, by a large net importation of gold during the early months of 1930.

The sudden contraction of bank credit, brought on by liquidation in the stock market, was not without effect on general business conditions. A portion of stock-market profits had undoubtedly been used from time to time during the boom days to purchase commodities. These funds had given an impetus to expenditures for luxuries, such as expensive living quarters, world tours, high-priced automobiles, and the like, the demand for which was curtailed materially when profits from stock speculation ceased. Hence, the industries providing such luxuries were first to feel the effects of the stock-market crash. Producers of articles of luxury, in turn, were forced to decrease their consumption of comforts as their own source of income was either shut off or reduced. Thus a general business depression was inaugurated, reflected in a pronounced decline of commodity prices, increasing unemployment, and decreasing commercial activity. The industrial-production index, issued by the Federal Reserve Board (adjusted for seasonal variations), which in 1929 averaged 119, declined by 36 per cent to 76 in 1933.[1]

[1] *World Economic Review*, 1933, U. S. Department of Commerce, p. 84.

Although the commodity-price level had remained fairly stable from 1923 to 1929, during a period of unprecedented industrial prosperity, the diversion of billions of dollars of the country's credit currency into speculative channels affected business adversely. Inflated security prices were suddenly deflated. The sequel to this collapse of stock prices in the fall of 1929 was the depression of the early thirties.

9–3. Banking Crisis of 1932–1933. *a. Background.* The rapid contraction of bank credit, following the stock-market crash of 1929, revealed a fundamental weakness in the commercial-banking structure of the United States. Many banks had extended liberal loans against collateral in the form of stock-market securities and mortgages, which were not self-liquidating, as were short-term commercial loans. They had apparently confused marketability with liquidity.

So long as there was an active market for these securities, and their prices tended upward, the problem of converting such collateral loans into cash when needed was very simple. But with the rapid decline in security prices beginning in the fall of 1929, it soon became apparent that the cash value of collateral was inadequate to meet the face value of loans. Marketability of collateral continued to exist in the sense that the collateral could be sold at a price, even if in many instances the price approached zero. But this was not liquidity of loans in the sense that they could be repaid at approximately their face value over a short period of time out of the proceeds derived from the pledged merchandise.

b. Bank Failures and Shrinkage in Currency. Unable to realize the necessary funds on their collateral to meet the demands of their depositors because many of their loans were "frozen," numerous banks throughout the country were compelled to suspend payments to depositors. From January, 1930, to March, 1933, 5,498 banks, having total deposits of 3.4 billion dollars, failed throughout the United States. These losses represented a serious shrinkage in accumulated monetary purchasing power of millions of depositors and were a major contributing factor to the rapid decline in commodity prices after 1929. The wholesale-commodity-price index fell from 96.5 in July, 1929, to 59.8 in February, 1933.

This price decline, in turn, made it impossible for many industries to continue production to cover their costs, some of which, such as interest, property taxes, etc., were relatively fixed. Consequently, unemployment increased rapidly between 1929 and 1933. But with mass unemployment, real purchasing power, growing out of production, continued to shrink—still further decreasing prices and marketability of goods. The whole economic structure of the country seemed to have been undermined, and governmental assistance was sought far and wide to aid in restoring confidence and reviving industrial activity.

c. Reconstruction Finance Corporation. In 1932 the Reconstruction Finance Corporation was organized by the Federal government. It was authorized to issue 1.5 billion dollars in notes, debentures, and bonds; it was also provided with ½ billion dollars of United States government funds. These 2 billion dollars of capital funds were to be used as loans to various commercial, agricultural, and banking organizations, as well as to insurance companies, railroads, and distressed farmers. Individual states also could request loans from the Reconstruction Finance Corporation for relief work.

d. Glass-Steagall Act. This bill, also passed in 1932, expanded the powers of the Federal reserve banks by permitting them to make loans to member banks more freely than theretofore; however, member banks at first availed themselves very little of these liberalized borrowing provisions. There was, in reality, no shortage of eligible commercial paper available for rediscount held by member banks. Only a few banks were unable to borrow under existing provisions of the Federal Reserve Act.

A second provision of the Glass-Steagall Act of 1932 authorized Federal reserve banks until Mar. 3, 1933, on approval of a majority of the Federal Reserve Board, to include United States government bonds as part of the collateral against Federal reserve notes. As previously indicated, this power of Federal reserve banks to issue Federal reserve notes against United States government obligations, renewed from time to time, was made permanent in 1945.

By purchasing government bonds in the open market on the part of Federal reserve banks, it was believed that Federal reserve funds would be made available to member banks without such banks incurring an additional burden of indebtedness to Federal reserve banks. As explained in the preceding chapter, the Federal reserve funds thus released made it possible for member banks to reduce their debts at the Federal reserve banks. This, it was hoped, would encourage a more liberal credit policy of member banks.

But in reality banks needed no additional funds, for they had more than adequate reserves. They were seemingly reluctant to invest in securities other than government bonds since they had learned from bitter experience that liquidity and marketability were not necessarily synonymous. Banks were, as one commentator expressed it, playing too safe for safety.

e. Ineffectiveness in Expanding Credit. Under such circumstances, the financial and banking measures instituted by the Federal government in 1932 to overcome the depression and to restore confidence in the banking structure, for the time being, proved rather ineffective. They did little toward augmenting real purchasing power of the people by providing productive reemployment for the millions who were out of work. The government was apparently proceeding on the theory that by liberalizing credit

through various governmental agencies, business revival could be brought about.

In reality the Federal government, by many of its credit measures in 1932 and 1933, was merely aiding in readjusting capital accounts of private enterprises, and was contributing but little to an expansion of the flow of the national income stream. For example, by lending a distressed farmer the funds to pay off his mortgage to an insurance company, which, in turn, invested these funds in government bonds, the Federal government merely substituted itself for the insurance company as creditor of the farmer. The farmer had no new assets except those realized from a possible reduction in interest rates. He now had a liability to the Federal government instead of to the insurance company. The insurance company, on the other hand, became the creditor of the government, for the farmer now was indebted to the government instead of to the insurance company. It was apparently believed that if the Federal government assumed private debts, these debts would be less burdensome because of lower carrying charges and because the government would be less severe in its collection policy than private creditors. In short, there was a shifting of creditorship but no expansion of credit.

f. Nationwide Run on Banks. The efforts of the Federal government to restore confidence in the banking structure of the country by its financial policy in 1932 proved ineffective. They were further weakened when the clerk of the House of Representatives was induced to make public the names of borrowers from the Reconstruction Finance Corporation. These included many prominent banking institutions, and the public interpreted such borrowing as an indication of weakness. The heavy withdrawals of bank deposits in the fall of 1932 and in the early months of 1933 indicated the extent to which public confidence in our financial institutions had been undermined. Fearing further bank failures, depositors continued to hoard their funds. This hoarding was clearly reflected in the increased issue of Federal reserve notes and the heavy withdrawal of bank deposits. The circulation of Federal reserve notes increased from 2.7 billion dollars on Oct. 21, 1932, to 3.4 billion dollars on Feb. 28, 1933, while member-bank deposits with Federal reserve banks decreased 250 million dollars during the same interval.

These expanded funds in the hands of the people were not entering into actual monetary circulation, for the wholesale-commodity-price index continued to decline from 64.0 in October, 1932, to 59.8 in February, 1933, while the Federal Reserve Board index of department-store sales decreased from 69 to 60 during the same period. The funds were largely being hoarded by frightened depositors. When early in 1933, moreover, general fear was expressed that the gold standard might be abandoned, a sudden demand for gold redemption of dollar claims set in. Gold reserves

held by Federal reserve banks and Federal reserve agents decreased rapidly, and the reserve ratio of gold to Federal reserve liabilities, which in December, 1932, had stood at 62.5, dropped to 51.3 in March, 1933. Meanwhile, in the middle of February, 1933, the state of Michigan declared an 8-day bank moratorium, closing all the banks of that state. This resulted in heavy withdrawals of funds from banks in adjacent states on the part of manufacturers and others in the industrial centers of Michigan. The area of monetary stringency spread swiftly beyond the borders of that one state. Within the 3 weeks prior to Mar. 4, 1933, more than 300 million dollars in gold coin and gold certificates had left the banks, largely for hoarding purposes, while the total stock of gold in reserve banks and the Treasury declined 624 million dollars or 18 per cent during the same period.

9–4. Commercial Banking Innovations from 1933 to 1935. In addition to the monetary changes made by the Democratic administration in 1933, previously discussed, important banking reforms also were instituted. A special session of Congress passed the Emergency Banking Act of 1933 on Mar. 9, while the banks throughout the country were closed by a presidential decree issued three days earlier.

a. Emergency Banking Act and Reopening of Banks. The Emergency Act of 1933 required the approval of the Secretary of the Treasury for the reopening of banks. It empowered the President to regulate or prohibit transactions in gold or in foreign exchange. Furthermore, it authorized the Comptroller of the Currency to appoint conservators for national banks, the condition of whose assets did not warrant their reopening. It also empowered Federal reserve banks to issue Federal reserve bank notes secured either by United States government bonds or commercial paper. Formerly such Federal reserve bank notes could be issued only against the security of United States government bonds.

Finally, in order to aid in rehabilitating some of the banks whose assets were not very liquid, the Emergency Banking Act authorized the Reconstruction Finance Corporation to purchase "capital notes" or preferred stocks in banks throughout the country. In 1933, the total of such purchases authorized represented an aggregate governmental investment of more than 800 million dollars in 4,500 banks, while the actual disbursements amounted to 250 million dollars. Many of these banks repaid the Reconstruction Finance Corporation and retired this preferred stock in the next few years. Nevertheless, their financial lives had been saved by this blood transfusion of public credit.

b. Guaranty of Bank Deposits. More drastic banking reform was undertaken by Congress in the Banking Acts of 1933 and 1935. With a view to restoring public confidence in the safety of bank deposits, the Act of 1933 provided for the guaranty of all bank deposits up to $2,500 from Jan. 1,

1934, to July 1, 1934. For subsequent years the guaranty plan provided full guaranty on the amount not exceeding $10,000 due each depositor in approved banks, and a 75 per cent guaranty on the amount in excess of $50,000 due each depositor. But the Banking Act of 1935 established the maximum insurance protection of only $5,000 per depositor.

The Federal Deposit Insurance Corporation was created, managed by the Comptroller of the Currency and two other appointees of the President. Under the provision of this act, the Federal government subscribed 150 million dollars for capital stock in the corporation, and Federal reserve banks subscribed an amount equal to one-half of their surplus as of Jan. 1, 1933. The stock in this corporation consists of no-par-value shares; it has no vote and is not entitled to payment of dividends. This represents a decided modification of the status of a business corporation, in which the stockholders have the rights to share in profits and to elect representatives on the board of directors.

Both member banks and nonmember banks of the Federal Reserve System are eligible for deposit insurance within the limits set by law. Compulsory deposit insurance is required of all member banks, while nonmember banks may have their deposits insured if they meet the legal requirements for such insurance. The assessment rate, or insurance premium, for each bank is equal to a semiannual payment of one twenty-fourth of 1 per cent of the average total deposits (less "float" or uncollected items) for each calendar day of the preceding 6-month period.

If a bank whose deposits are guaranteed should be unable to meet its demand obligations, depositors, covered by the insurance, will not lose, for the law provides that in case of a bank failure, a new national bank shall be organized to assume its deposits. The guaranty funds will be used to provide cash to offset losses sustained by liquidating the assets of the insolvent bank.

There has been considerable opposition to deposit guaranty in the United States on the ground that it would lead to unsound banking practices on the part of speculatively inclined bankers, and that it imposed an additional financial burden on conservatively managed banks that needed no deposit insurance. No system of deposit insurance can prevent losses due to dishonest or inefficient management; but assuming the necessary competence and honesty of bankers, there is reason to believe that a system of deposit insurance can be established on sound actuarial principles, even as are other types of property insurance.

c. Separation of Commercial and Investment Banking. The Banking Act of 1933 also required commercial banks to divorce security affiliates that had been established during the boom days preceding the depression. This meant segregating the functions of investment banking from those of commercial banking. It was intended to prevent the recurrence of the

high degree of illiquidity of many commercial bank portfolios. As previously indicated, commercial banking is intended to provide short-term credit for working capital and not funds for long-term investments in fixed capital assets. Such fixed capital should be financed out of accumulated money savings and not with funds created by commercial banks. Prior to 1929 the popularity of corporate securities induced many commercial banks to combine their functions with those of investment banks in financing the flotation of new security issues. The resultant inflation of credit inaugurated the era of speculation, which culminated in the stock-market crash in October, 1929. By requiring the segregation of commercial banking from investment banking, the Banking Act of 1933 clearly recognized a sound financial principle, the application of which had formerly been left to the judgment of individual bankers.

d. Branch Banking. The Banking Act of 1933 attempted to correct still another defect of the American banking system, which had been glaringly exposed by the failure of over 10,000 banks in the United States since 1921. In 1929, there were still over 20,000 commercial banks in the United States chartered under either state or Federal laws. State banks may or may not be members of the Federal Reserve System. The possibility of effective banking control under any centralized governmental authority is rather remote as long as there are thousands of independent unit banks chartered either under the laws of 48 separate states or under Federal laws.

With a view to decreasing the number of individual banking units and as a further means of bringing banks under the control of the Federal Reserve System, the Banking Act of 1933 permitted national banks having the required minimum capital to establish state-wide branches in those states that give this permission to their own state banks. It was hoped that this privilege would encourage the growth of large banking institutions within the Federal Reserve System, which would have the advantage of competent banking management and supervision.

It may be argued that a few large banks with state-wide branches give greater safety to depositors than do many small unit banks, not only because of the increased possibility of more efficient management but also because of wider diversification of risk in their loans and investments. Moreover, branch banking would make for greater uniformity in interest rates over the country than has prevailed under our unit banking system. Finally, branch banks, by pooling till money or cash in their own vaults, would reduce the percentage of such cash normally required to meet depositors' demands.

On the other hand, opponents of branch banking claim with some validity that it would make banking impersonal and fail to cater to individual needs. Branches would become merely distant offices of large, centralized

banks. The intimate relations between local bankers, with an understanding of local problems and customers, would be lost. Funds would be sucked into large financial centers, while the rest of the country would be at the mercy of powerful financial interests.

e. Loans on Improved Real Estate. The Banking Act of 1935 authorized national banks to make loans secured by first liens upon improved real estate, including farm as well as business and residential properties. No such loan shall exceed 50 per cent of the appraised value of the property offered as security, nor can it be made for a period of more than 5 years; however, first-mortgage loans on real estate may also be made by national banks up to 60 per cent of the appraised value of the property for a 10-year term if annual installment payments are sufficient to amortize 40 per cent or more of the principal of the loan within 10 years. But such loans, in the aggregate, may not exceed the capital and surplus of the bank making them or 60 per cent of its time and demand deposits, whichever is greater. At the close of 1944, all insured commercial banks in the United States held 4.3 billion dollars in loans on real estate. But this represented only 4.2 per cent of their total loans and investments.

This liberalization of the powers of commercial banks would appear to be a confusion of commercial with investment banking. As long as a ready market exists for real-estate mortgages, commercial banks may experience no difficulty in realizing cash on these mortgages to meet demand deposits. Moreover, the insurance of bank deposits may militate against sudden runs on banks, while the expanded control over member-bank reserve requirements and open-market operations, vested in the Board of Governors of the Federal Reserve System under the Banking Act of 1935, may all serve to prevent the "freezing" of commercial-bank funds in the real-estate loans. Nevertheless, this expansion of the credit-creating functions of commercial banks, authorized by the Banking Act of 1935, seems to be a violation of the principles of sound commercial banking in the interest of easy credit, with a view to stimulating economic activity. One should not lose sight of the fact that every extension of credit involves a corresponding creation of debts, and that an excessive "frozen-debt" structure was one of the major contributing causes of the financial and economic crash of 1929.

9–5. Governmental Lending. Even before our entry into the Second World War there was an unmistakable trend toward Federal assumption of many of the traditional private banking functions in our economy. This trend is indicated in the following résumé of governmental credit agencies, created during the depression of the thirties. The partial collapse of private commercial and investment credit agencies in 1932–1933 necessitated such governmental intervention to meet the credit stringency. In consequence, several Federal institutions were created that took over many

functions formerly performed by private banks. Reference has previously been made to the creation of the Reconstruction Finance Corporation in 1932.

a. Illustrations. The *Federal Home Loan Bank Act* of 1932 provided the necessary financial agency, in the form of 12 regional Home Loan Banks supervised by the Federal Home Loan Bank Board, to help financial institutions that had "frozen" assets in the form of mortgages. Any approved building and loan association, insurance company, or savings bank might join the Federal Home Loan Bank system and obtain loans on sound mortgages. These savings institutions were buttressed by a central banking system, but they remained private enterprises.

Shortly after the financial crisis of 1933 the Democratic administration took positive steps to further expand commercial and investment credit. The *Agricultural Adjustment Act* of 1933 authorized the Reconstruction Finance Corporation to make available to the Farm Loan Commissioner the sum of 200 million dollars for loans to farmers, secured by farm mortgages and farm crops. Furthermore, an amendment to the Federal Farm Loan Act of 1916 provided for the issue of bonds not to exceed 2 billion dollars for the purpose of refinancing farm mortgages at lower rates. Similarly, the *Home Owners' Loan Corporation Act* of 1933 authorized the issue of bonds up to 2 billion dollars for the purpose of refinancing home mortgages. The corporation could make loans for taxes, maintenance, and repairs, as well as to recover homes lost by foreclosures.

In order to stimulate the home-construction industry, the *National Housing Act* of 1934 provided a comprehensive program of home financing and mortgage insurance. Financial institutions making loans for alterations and repairs to homes had their loans insured by the Federal government up to 20 per cent of the total of such loans. Furthermore, the act provided for a program of mutual mortgage insurance and authorized the establishment of national mortgage associations with authority to deal in first mortgages and to borrow money through the issue of securities. A corporation was created under the supervision of the Federal Home Loan Bank Board to insure accounts of the Federal Home Loan Bank system. Under the *Federal Housing Act* of 1937, creating the United States Housing Authority, government loans could be made to public-housing agencies to aid in the construction of public low-rent housing for families of low incomes.

In addition to these various governmental agencies intended to provide either long-term or intermediate credit, several Federal organizations for short-term credits have also been created since 1933. Under the *Farm Credit Act* of 1933 an organization was established to make loans for the growing and marketing of agricultural products. A Production Credit Corporation and Bank for Cooperatives was provided for each of the

twelve Federal Land Bank cities. Furthermore, the Farm Credit Act of 1935 further liberalized the provisions of various earlier acts intended to aid the farmers.

To aid in financing our foreign trade, two Export-Import Banks were established by the Federal government in 1934, the first to extend credit facilities to those desiring to sell to Soviet Russia, and the second, to those wanting to do business primarily in Latin American countries. These banks have played an important part in financing our foreign trade ever since their inception.

b. Effects. By 1940, some thirty government corporations and credit agencies had been created, reporting consolidated assets of over thirteen billion dollars. All these Federal credit agencies represented a departure from traditional American banking practice. They established the Federal government as a distinct competitor in many fields with private banking. Funds to provide the necessary capital to finance the vast undertakings of the Federal government since 1933 were obtained largely from governmental loans. From 1933 to 1941 the public debt increased by 27 billion dollars. A part of this newly created public debt represented government loans to private enterprises, repayable in whole or in part to the government out of proceeds from private commercial transactions.

But in the face of these encroachments of governmental lending agencies in the field of private banking, the traditional banking system of the United States has continued to function as the primary source of bank credit, both before and during the Second World War.

9–6. Commercial Banking System in the Second World War. The many monetary and banking changes of the thirties aided our private commercial banking system in its subsequent problems of war finance. Idle reserve funds had accumulated in banks not only because of dollar devaluation and of the large inflow of foreign funds prior to the outbreak of the war in 1939 but also because of the declining volume of borrowing from banks by business concerns to finance working-capital requirements.

Of particular importance during the war period was the increase in commercial-bank lending to the government. These loans contributed to a steadily expanding volume of demand deposits in our war economy. At the end of June, 1945, nearly one-third of the gross Federal debt of 257 billion dollars was held by commercial banks, exclusive of Federal reserve banks.

The liquidity of these government obligations, held by banks, depended on their shiftability to obtain funds necessary to meet demands of depositors at all times. Upon our entry into the Second World War in December, 1941, Federal reserve authorities assured the government that they were prepared to use their powers to see to it that an ample supply of funds would be available at all times to finance the war effort.

Inasmuch as expanding wartime commercial bank deposits arose directly out of the increasing Federal debt, held by banks, they were not related to normal trends in business activity. Formerly, in our economic life, a decline in demand deposits would ordinarily have been accompanied by a shrinkage in loans and discounts and vice versa. But because of the quantitative importance of government obligations in the earning assets of commercial banks, a possible postwar decline in business activity will not necessarily result in a significant decrease in bank deposits. We may therefore anticipate a higher degree of stability in bank deposits as compared with prewar years, irrespective of general business trends, since these deposits rest so largely on government obligations rather than on business loans.

How these deposits will be used by their owners is difficult to foretell. If depositors prefer to hold large cash balances, their idle funds will not exert an inflationary pressure on prices. But there is always the possibility that they may be spent extensively to buy actual goods over a short period of time. Such an increase in the circulation of checkbook money would exert decided inflationary pressure on prices.

9–7. Wartime Open-market Operations of Federal Reserve Banks. In accordance with their declared policy to provide ample funds to finance the war effort, Federal reserve banks made large purchases of Treasury obligations in the open market in 1942 and subsequently. Their holdings of government securities increased from 2.5 billion dollars in June, 1942, to 22 billion dollars in August, 1945, or almost ninefold. The increase of some 19 billion dollars in reserve bank purchases of Federal obligations in slightly over three years was several times as great as the purchases of "Governments" by the entire banking system during the First World War.

Federal reserve policy in the Second World War was dominated by considerations for the Treasury's fiscal requirements. Two immediate objectives served as guides in adjusting open-market operations since early 1942. The first was to offset the effect on member-bank reserves of constant currency withdrawals by the public. Currency and coin in circulation increased from about 11.2 billion dollars at the end of 1941 to 28 billion dollars in October, 1945, or 150 per cent. This expansion of currency in circulation was continuous during the war, although the rate of expansion declined somewhat during 1945. The second objective was to anticipate the effect of war-loan drives and other Treasury operations on member-bank reserves so that the reserve position of the banking system would not interfere with complete banking cooperation in the Treasury financing program.

A third objective was attained as a corollary of the other two, namely, a strong and stable market for government bonds. Had it not been for these heavy open-market purchases of government securities by Federal

reserve banks, member-bank reserves would in all likelihood have been exhausted long before the end of the war in 1945. The Board of Governors might have seen fit to reduce reserve requirements of member banks to the minimum allowed by law, but this would not have permitted the degree of direct and active Federal reserve credit control made possible by open-market purchases.

9-8. A New Type of Wartime Credit Policy, Option Accounts. Whenever actual member-bank reserves approached the minimum required, open-market purchases by Federal reserve banks were not necessarily effective in meeting the reserve problems of individual member banks. Such purchases by Federal reserve banks might increase aggregate member-bank reserves above legal requirements, but the new reserves would not flow automatically to the particular banks that needed them. The traditional type of member-bank rediscounting to increase reserves was not a satisfactory solution, partly because of the small amount of commercial paper held by member banks and partly because of the prejudice banks have had against borrowing from Federal reserve banks. To be sure, individual banks could also replenish their reserves by selling some of their long-term earning assets, or have recourse to interbank loans.

In order to enable individual banks to adjust their reserves from day to day and yet safely invest temporarily idle funds in Treasury obligations, a new type of Federal reserve bank credit was created in 1942. The Open Market Committee announced that Federal reserve banks would stand ready to buy Treasury bills from any holder at a fixed rate of three-eighths of 1 per cent discount until maturity. When desired by member banks, such sales to Federal reserve banks could be made under repurchase option, whereby a selling bank retained the privilege of reclaiming these bills at any time before maturity, losing only the discount for the time they were held by the Federal reserve banks.

This device provided an almost perfect method for adjusting reserves of individual member banks. For all practical purposes these Treasury bills became analogous to excess member-bank reserves. They made possible putting actual excess reserves of lawful money to work by the banks, without impairing the liquidity of their earning assets. Moreover, Treasury bills made reserves available when and where needed; they offered an acceptable alternative to discounting by member banks, which retained a traditional aversion to borrowing from Federal reserve banks. Member banks could also earn a small return on what amounted to excess reserves without sacrificing liquidity.

9-9. Support of Bond Market. Furthermore, through its open-market purchases of government securities the Federal reserve system supported the bond market for public issues and helped to maintain a fixed pattern of interest rates among various maturities of Treasury obligations. This

maintained the liquidity of the entire marketable public debt, so long as all marketable governmental securities could be converted into Federal reserve funds at their face value, when needed. "The policy of maintaining stability of interest rates and prices of government securities" made "virtually the whole public debt the equivalent of money." [1] Commercial banks thus inclined to convert more and more of their low-interest-bearing short-term Treasury issues into long-term marketable Federal obligations yielding higher returns.

9–10. Dilemma Facing Federal Reserve Banks at the Close of the Second World War. The dilemma that had faced Federal reserve banks at the end of the First World War in their effort to curb inflationary and speculative activity was accentuated by the "easy-money policy" that had been pursued during the Second World War to aid in Treasury war financing.

The traditional methods of active credit control—discount rates, member-bank reserve requirements, and open-market operations—proved to be rather ineffective instruments of control under such conditions. Raising Federal reserve discount rates to curb further bank credit expansion would have had a depressing effect on the market value of government securities, which would have caused losses to owners of the public debt.

Sale of government securities from the investment portfolios of Federal reserve banks, with a view to contracting bank credit, would likewise have had a depressing effect on market prices of government obligations. On the other hand, continued open-market purchases of government issues, with a view to maintaining their face value, not only would have made these bonds the equivalent of liquid funds in the hands of bondholders, but also every net purchase by Federal reserve banks would have released more funds to feed the flames of inflation. In the face of this dilemma Federal reserve banks were relatively powerless in their efforts to curb the growing threat of price inflation at the close of the war as long as they maintained their policy of supporting the bond market and maintaining a fixed pattern of interest rates on Treasury obligations.

Far too large a percentage of the cost of the war had been financed by the expansion of bank funds and not enough out of actual savings and taxes. The highly liquid condition of the marketable public debt would scarcely have existed at the end of the war if the war had not been financed so extensively through sale of low-interest-bearing readily marketable securities to the banking system. It is questionable whether the bondholding public would have liquidated their holdings very extensively at a substantial loss in face value, with a tightening of the money market and

[1] ROBINSON, ROLAND I., Monetary Aspects of National Debt Policy, in *Postwar Economic Studies*, No. 3, p. 74, Board of Governors of the Federal Reserve System, December, 1945.

higher interest rates at the close of the war. But in view of the large holdings of Treasury obligations by banks, a rise in interest rates might have had serious repercussion on the entire banking system because of resultant declines in asset values with rising interest rates.

Whereas in 1921 more than three-fourths of the earning assets of commercial banks consisted of loans to private interests, while less than 11 per cent were Federal government issues, at the close of the Second World War aggregate loans by banks to private interests amounted to around 20 per cent of their earning assets, while nearly three-fourths of the total were government securities. These obligations, as we have seen, were all practically the equivalent of liquid funds, available for a substantial credit expansion at the discretion of member banks.

9–11. Changing Pattern of Private Commercial Banking. The significant prewar and wartime change in the asset portfolios of commercial banks from loans to private concerns to loans to the government raised still another question. The validity of paying interest by the government to banks on deposit currency created by the banking system against Federal obligations has been seriously questioned. Moreover, criticism has frequently been voiced of the fractional reserve principle, which permits banks to extend credit in excess of their actual holdings of lawful money. While in the past deposit currency was ordinarily created against self-liquidating private commercial loans, which were intended to be repaid out of the sale of the products whose production was financed with the aid of such loans, wartime deposit currency was created chiefly by bank loans on governmental debts. Neither the theory that commercial bank credit is valued more highly than private or personal credit, and so demands a price, nor the assumption that bank loans to the government will be repaid out of the sale of goods financed with such loans warrants the payment of interest on commercial bank credit to the Federal government against its own obligations. "The banking system must earn its living and justify its existence by supplying credit for business and consumption, not by relying on its ability to monetize the public debt." [1]

9–12. Proposals for Postwar Banking Reforms. In view of these considerations, several proposals for further banking reforms have been advanced by various monetary authorities not only to restore to Federal reserve banks, or possibly grant to a newly created monetary authority, the effective control over the extension of bank credit, but also to curb the inflationary threat during and after the Second World War.

a. Special Nonmarketable Government Securities. According to this proposal, Congress would authorize the issue of a special security to be

[1] *Op. cit.*, p. 78. For an opposite viewpoint see J. Carl Poindexter, A Critique of Functional Finance through Quasi-free Bank Credit, *American Economic Review*, vol. 36, No. 3, pp. 311*f.*, June, 1946.

exchanged for a substantial part of the Federal obligations held by commercial banks. These new securities would be nonmarketable but made redeemable at the central bank in case of deposit withdrawals. They would be made eligible for discount with Federal reserve banks at rates set by the Board of Governors or other monetary authority and be redeemable at face value at the option of the government. A low rate of interest would be allowed on these special issues to cover the cost of checking and collection services provided by banks.

Such a proposal, if put into effect, might result in "freezing" a substantial part of the public debt, and by controlling the central bank discount rate, permit it to be "thawed out" when necessary to maintain a stable supply of bank credit to meet legitimate business needs. The discount rate would thus be reestablished as an effective instrument of central bank credit control. Moreover, open-market operations would again become positive means of controlling bank credit, assuming they were no longer used to support the bond market. In other words, interest rates would have to be permitted to fluctuate in accordance with changing market conditions. Stabilizing the supply of bank credit and maintaining a fixed pattern of interest rates through credit controls are incompatible objectives of central bank policy.

Various objections may be raised to this proposal, not only because it suggests a degree of central bank control over commercial bank activities, which is contrary to American banking tradition, but also because of its possible adverse effect on commercial bank earnings.

> [But] in modern economic systems, the supply of money must be subject to government regulation if monetary instability is to be avoided. Because money has come to consist predominantly of the demand deposit obligations of commercial banks, these institutions—though privately owned—are unavoidably in the public sector; they must be subject to public regulation to a degree that is true of no other part of the business community.[1]

b. 100 Per Cent Reserve Proposal. Another banking reform advocated by some competent economists during the thirties was revived at the close of the Second World War. The proposal is commonly referred to as the "100 per cent reserve" plan. A bill introduced in Congress in 1945 for monetary reform incorporated the main features of this plan.

Under the proposed 100 per cent reserve plan, all commercial banks would be required to hold 100 per cent in lawful money against their demand deposits, instead of the traditionally required fractional reserves. The power to create deposit currency or checkbook money by making bank loans would be taken from commercial banks; it would be vested in the Federal Reserve System or any other appropriate monetary authority

[1] *Op. cit.*, p. 78.

created by Congress. Commercial banks would continue to function as custodians of funds entrusted to them by their depositors. They would obtain their earnings primarily from various service charges to customers incidental to handling their accounts. But they would no longer be permitted to derive a profit from making loans and investments other than the loan of funds invested by their stockholders or deposited in savings accounts by their customers.

In order to put this plan into effect, it is proposed that in the future the Treasury borrow directly from the Federal Reserve System sufficiently to pay off its obligations to commercial banks. To prevent the expansion of bank credit against these new funds, the Board of Governors would raise the reserve requirements of member banks until they reached 100 per cent of demand deposits. A nominal rate of interest might be paid to banks on these reserves to help meet expenses of the banking system.

c. Substitution of Currency for Bonds. A modification of this plan proposes that Federal reserve banks, or whatever monetary authority might be set up, purchase outright at face value the government securities held by commercial banks with an issue of new currency, and so retire a portion of the interest-bearing public debt. The new currency would be made a noninterest-bearing government obligation. Any subsequent expansion or contraction of currency would be under some form of central or government banking control. This control would presumably be exercised with a view to maintaining monetary stability and preventing, by monetary means, postwar periods of either inflation or deflation. Moreover, it would effect a substantial saving in interest payments on the Federal debt.

d. Control of Credit and Currency by Government. Once banks had achieved a 100 per cent cash reserve, by putting one or the other of the above proposals into effect, they would be required to hold 100 per cent in ready cash against demand deposits at all times. Any subsequent change in the supply of both checkbook money and pocketbook money would be controlled by the designated monetary authority. In return for a nominal service charge, commercial banks would continue to handle checking accounts and make collections, as heretofore.

If a 100 per cent reserve proposal were to be adopted, Federal deposit insurance would become unnecessary, since depositors, large and small, would no longer have to fear for the safety of their deposits. Moreover, overstimulation of investment, with the aid of expanded bank credit, would be a matter of the past. Investment would depend on voluntary saving instead of credit expansion.

This does not necessarily imply that the desired equilibrium between saving and investing would be maintained in the private sector of our

economy without other types of governmental intervention from time to time to maintain stabilized economic conditions. Economic stabilization and monetary stabilization are not necessarily synonymous concepts. Nevertheless, reasonable monetary stabilization would contribute toward a higher degree of economic stabilization in our postwar economy than was the case in the past. The foregoing proposed banking reforms merit the careful consideration of students of postwar monetary and banking problems.

Guide Questions on Text

1. Contrast the status of commercial banking in the United States at the close of the First World War with that at the end of the Second World War.
2. Account for the prosperity of the twenties, when there was little, if any, rise in the general level of commodity prices.
3. What was the dilemma confronting Federal reserve banks growing out of the inflow of gold during the twenties?
4. What were the reasons for the speculative stock-market boom of the late twenties?
5. Trace critically the Federal reserve policy toward this wave of speculation.
6. What circumstances brought on the banking crisis of 1932–1933?
7. Analyze the several governmental measures adopted (prior to the New Deal) to meet this crisis.
8. Evaluate critically the several commercial banking reforms inaugurated by the Federal government between 1933 and 1935.
9. Account for the expansion of governmental banking functions since 1933, and illustrate the nature of public lending agencies.
10. Do you think public lending agencies and private banking can be reconciled in our economy? Why, or why not?
11. Trace the functions performed by commercial banks during the Second World War.
12. Criticize the policy pursued by Federal reserve banks during the Second World War, and suggest what alternative policy might have been followed.
13. What was the nature of the dilemma facing Federal reserve banks at the close of the Second World War?
14. How was the pattern of private commercial banking altered by the Second World War?
15. Analyze critically two proposals that have been advanced for banking reform aimed at curbing the inflationary threat existing at the close of the Second World War.
16. How would these proposals aid in restoring to central banking authority effective control over the extension of bank credit?

Topics for Investigation

1. Economic consequences of public short- and long-term lending.
2. Maintenance of fixed patterns of interest rates on government obligations through central banking policy.
3. The banking and the money functions of commercial banks.
4. Pros and cons of nationalization of banks.
5. Changing objectives of commercial banks.
6. Wartime credit control by Federal reserve banks.

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See also Selected References, Chap. VIII.

CHAPTER X

BUSINESS CYCLES

10–1. Nature of Business Cycles. The continuity of industrial activity in modern capitalistic countries has been intermittently interrupted by economic disturbances, accompanied by more or less pronounced changes in price levels, in industrial output, and in volume of employment. The recurrence of periods of brisk business activity, followed by periods of business stagnation, has been so persistent that these movements have come to be spoken of as business cycles.

A business cycle, therefore, may be defined as a series of changes in business activity commonly characterized by periods of alternating prosperity and depression. These fluctuations in business activity have come to be viewed as a characteristic of a capitalistic economy, based on individual enterprise, freedom of contract, private property, the profits motive, and the price system. They have become especially severe with the development of our modern age of power machinery and roundabout, or capitalistic, production.

No two business cycles have been alike, either in intensity or in duration, although every cycle is ordinarily composed of a complete upward and downward swing in business activity. Furthermore, no two cycles have revealed precisely the same upward and downward movements of prices, although inflation has often accompanied prosperity and business depressions have been heralded by price deflation.

10–2. Brief History of Business Crises in the United States. The phase of a business cycle that first attracted attention among writers was the crisis or turning point, when, over a relatively short period of time, industrial prosperity ceased and business recession set in. Historians have long since observed these recurring crises and have, therefore, come to measure business cycles from one crisis to another.

After the advent of the Industrial Revolution, England, in 1793, had its first general regressive movement of commodity prices and industrial output; a similar phenomenon recurred at varying intervals in the following century and a half.

The United States likewise experienced during the nineteenth century many periods of business stagnation, during which industrial activity was curtailed and employment reduced.

The first notable crisis in the United States occurred in 1817; it was brought about largely by violent trade adjustments after the War of 1812. In 1837, the first crisis which was international in scope was experienced. This was followed 5 years later by another business crisis in the United States. These crises were brought on largely by the rapid westward expansion, overspeculation in land, inflation of state bank-note issues, and the financial disorganization due to the discontinuance of the Second Bank of the United States in 1836.

The next pronounced business disturbance, which also affected European countries, came in 1848. It was followed 9 years later by the crisis of 1857, which, in turn, had superseded an extended period of prosperity and of rising prices, traceable largely to the discovery of gold in California. In 1860, just before the outbreak of the Civil War, there was a slight business disturbance in the United States.

In 1873 this country experienced one of the most severe crises in its history to that date. It followed a wave of wild speculation, especially in the direction of railroad expansion after the Civil War. In 1884 came another crisis, followed by a year of business depression. The crisis of 1890, precipitated by the failure of a large banking house in London, was felt only slightly in the United States. But in 1893 a very pronounced crisis set in, which was superseded by a period of business depression lasting 4 years.

The rapid industrial expansion of the United States was again temporarily checked in 1900, when Europe also passed through a severe crisis. In 1903, money became so tight in New York and in other financial centers that the rapid liquidation of securities precipitated what has been called the "rich man's panic." This financial panic, however, caused only a slight retardation of business activity. In 1907, another severe crisis occurred, inaugurated by the failure of the Knickerbocker Trust Company in New York. This business disturbance was international in scope; it was followed by a serious industrial depression, which lasted through 1908.

After a period of business recovery the outbreak of the European conflict in 1914 brought on another crisis, owing to the sudden withdrawal of funds from New York by European countries. In the crisis of 1920, following the short boom after the close of the First World War, the United States experienced the most violent collapse of prices in its history. Average wholesale-price indices between 1920 and 1921 fell from 272 to 151 (1913 base = 100) (see Table 3 on p. 130).

After 1921 several minor business recessions, each of about three years' duration, occurred. But in general, as noted in the preceding chapter, the trend in business from 1922 to 1929 was upward. This is indicated in the production index issued by the Board of Governors of the Federal Reserve System, reproduced in Table 4.

TABLE 4. INDUSTRIAL-PRODUCTION INDEX, UNADJUSTED FOR SEASONAL VARIATIONS *

(1935–1939 = 100)

Year	Index number	Year	Index number
1919	72	1934	75
1920	75	1935	86
1921	58	1936	103
1922	73	1937	113
1923	88	1938	89
1924	82	1939	109
1925	90	1940	125
1926	96	1941	162
1927	95	1942	199
1928	99	1943	239
1929	110	1944	235
1930	91	1945	203
1931	75	1946	170
1932	58	1947	187^P †
1933	69		

* *Federal Reserve Bulletin*, May, 1947, p. 579.
† *P* = preliminary.

Chart 5 presents vividly the cyclical movement of business activity from 1830 to the end of the Second World War, in 1945.

The upward trend in productive activity from 1922 to 1929, accompanied by slightly receding commodity prices, led many to believe that at last the business cycle had been conquered. Business was prosperous, profits were increasing, and real wages were advancing, while at the same time there was no pronounced rise in general commodity prices. Faith in this new order of things engendered such a wave of speculative enthusiasm among those who wanted to purchase a share in the growing economic prosperity of the country that a collapse sooner or later was inevitable. As previously explained, the credit resources of the country were being utilized to an increasing extent from 1926 to 1929 in security speculation, with the resultant price inflation of corporate stocks.

The crash in the speculative-securities market was followed by an extended period of business depression, which culminated in the banking crisis of 1933; its severity prompted drastic recovery measures on the part of the Federal government. But the artificially stimulated recovery was not of long duration. There was a short but sharp recession from 1937 to 1938. Full recovery of economic activity was not achieved until we engaged in our expanded program of defense production in 1940. The war

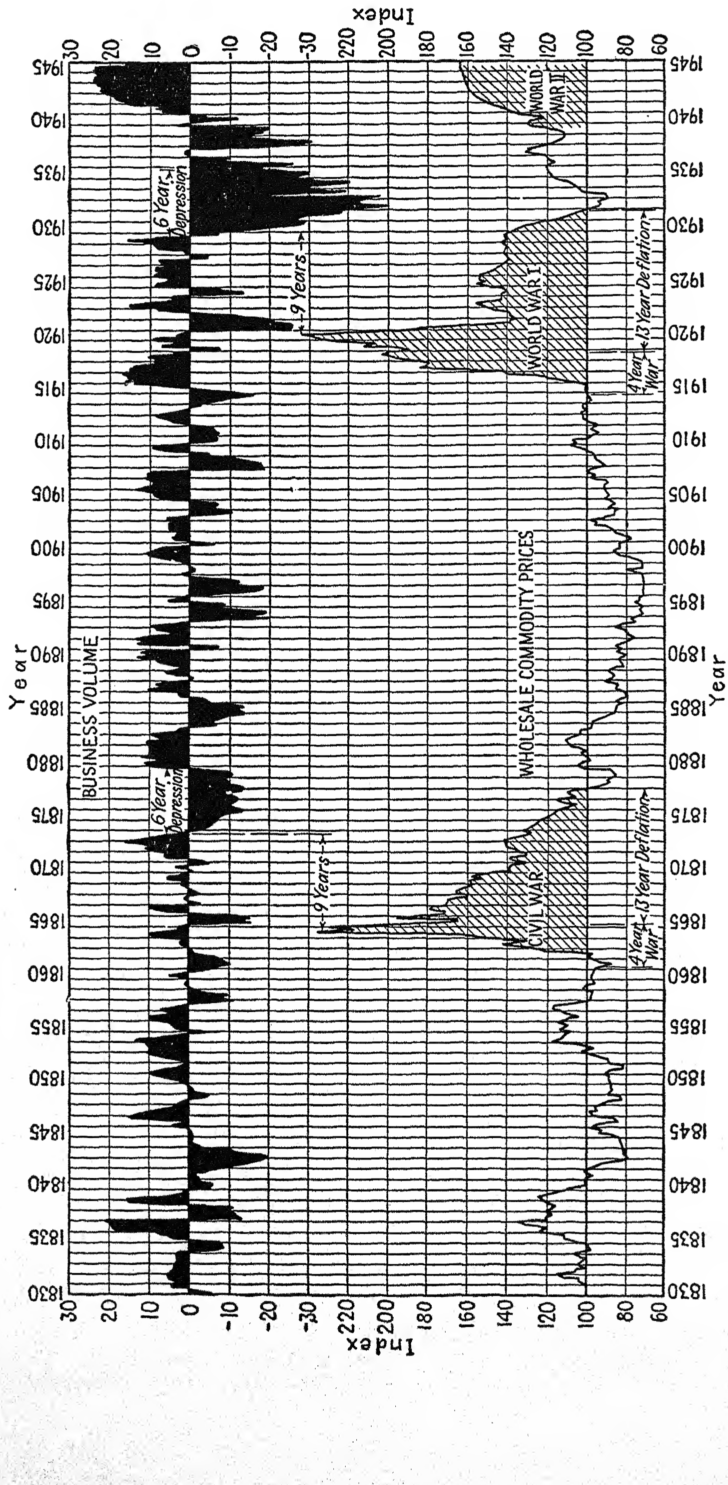

CHART 5. Cyclical fluctuations in volume of business and wholesale commodity prices.

boom of 1941 to 1945, following the depression of the thirties, was generated by all-out production for war. It lacked the essential characteristics of a period of business prosperity. It was not accompanied by an excessive supply of civilian goods looking for buyers, but rather by an excess in the amount of monetary buying power seeking goods, owing to wartime currency expansion.

10-3. Characteristics of Different Phases of Business Cycles. For purposes of analysis, business cycles are commonly divided into four distinct phases, designated as (1) the period of prosperity, (2) the crisis (period of liquidation), (3) the period of depression, and (4) the period of gradual recovery. Let us note the outstanding characteristics of each one of these phases.

a. Prosperity. During the period of prosperity, prospects for business profits are bright. Caution on the part of the enterpriser is gradually superseded by bold action. Worn-out industrial equipment is replaced by better tools and machinery. New industries are established, while old industrial plants are improved and expanded. The demand for industrial raw materials and producers' goods increases more rapidly than the demand for consumers' goods. Thus, the prices of these commodities tend to advance faster than the prices of consumers' goods.

In order to aid in the financing of industrial enterprises, new securities are marketed. Stocks in industrial corporations prove particularly attractive because of anticipated larger dividends with increasing profits. Outstanding bonds, yielding a fixed rate of interest, tend to decline in market value. New bond issues can be sold only by raising their interest rate. Wages gradually rise as the shortage of labor increases, and the demand for still higher wages becomes increasingly insistent. There is relatively little unemployment. Everyone is spending freely, and the accentuated demand, unless met by a constantly increasing supply of products —as during the decade from 1921 to 1930— tends to raise commodity prices.

The wave of prosperity becomes cumulative. The increased demand for consumers' goods, in turn, increases the demand for producers' goods. When increasing profits are anticipated from rising commodity prices, speculative activity in commodities, as well as in securities, becomes the order of the day. On the other hand, when business profits grow in spite of stable commodity-price levels, speculation in securities, reflecting the capitalized value of anticipated larger profits, runs rampant.

As a result of intensive industrial, as well as speculative, activity, the volume of bank loans and deposits increases rapidly. Businessmen may borrow heavily to finance their capital requirements, or they may issue new securities, the purchase of which will be financed largely with borrowed bank funds. Thus bank credit is expanded and the prices of articles in unusual demand, whether commodities or securities, tend to advance.

Intensive utilization of bank funds for speculative purposes is ultimately reflected in rising interest rates and in increasing costs of funds to those industries dependent on bank loans for working capital. Speculative profits withdrawn for consumption expenditures, in turn, serve to stimulate productive activity, while speculation continues apace. Finally, voices make themselves heard, at first sporadically, then more generally, that speculative prices are excessive or unreasonable. Pressure is exerted here and there to curb speculative enthusiasm. Ultimately it makes itself felt, and (abruptly or gradually) sentiment changes. Confidence is converted into doubt, enthusiasm into skepticism, and certainty into uncertainty. People curtail their buying of nonessentials and purchase only those goods absolutely necessary to their livelihood. Further industrial expansion is retarded by manufacturers, while production decreases, and unemployment or part-time employment increases. Thus the period of prosperity comes to an end.

b. Crisis or Liquidation. In order to meet maturing obligations securities, as well as merchandise, are "sacrificed." Those who cannot pay their debts when called upon to do so are either "sold out" or are forced into insolvency. On the other hand, desperate efforts are made to obtain ready cash. Merchants advertise "bargain buys" and "reduction sales" at "panic prices." Unable to continue profitable production, some industries shut down, while others work only part time. Unemployment increases and money wages decline. Prices of most common stocks and many commodities continue downward.

The curtailment of industrial output and the liquidation of securities or commodities, often bought at high prices with borrowed funds, gradually diminish the amount of outstanding bank loans and discounts. Bank reserves thus tend to increase and interest rates to decrease. But many businessmen become discouraged, timid, and pessimistic. The former bustling activity deteriorates into business stagnation as the period of liquidation ends and that of depression sets in. The pronounced decline in the physical volume of production during the period of liquidation gradually becomes less accentuated during the period of depression. Trade is below normal and uncertain. Many industries shut down entirely, while millions of unemployed idly walk the streets of great industrial centers.

c. Depression. The consumption of a certain quantity of goods goes on, even though production is curtailed. Although the standards of living of some individuals may be lowered because of the reductions in their income, a moderate demand for goods continues. As the consumption of many commodities for the time being exceeds production, the surplus stock of goods is gradually used up, and eventually a shortage of essential commodities manifests itself. Meanwhile, the abundant labor supply

tends to force down money wages of labor, and bank loans can be obtained by enterprisers at lower interest rates. Production costs also tend toward a lower level because of greater efficiency developed in the management of business. With the scale of production costs reduced, goods may again be produced profitably but at a relatively lower level of prices.

During the period of business depression, the financial situation ordinarily improves. At the time of the crisis there may be some bank failures,

TABLE 5. CHARACTERISTIC CONDITIONS IN PHASES OF THE BUSINESS CYCLE

Characteristic conditions	Period of prosperity	Crisis and period of liquidation	Period of depression	Period of recovery
Industrial output..............	High	Decreasing	Low	Slowly recovering
Industrial expansions...........	Rapid	Discontinuing	Very little	Slowly resumed
Commerce and trade employment	Extensive	Declining	Limited	Expanding
	Abundant	Decreasing	Scarce	Increasing
Business inventories............	Large	Decreasing	Low	Increasing
Capital goods construction......	High	Declining	Low	Expanding
Attitude toward money.........	Liberal spending	Hoarding begins	Hoarding	Spending resumed
Money wages..................	Rising rapidly	Declining	Low	Slowly rising
Bank loans and discounts.......	Extensive	Restricted	Small in volume	Gradually expanding
Bank reserves.................	Low	Increasing	Large	Slowly decreasing
Discount rates.................	Rising	High	Low	Fairly low
Level of commodity prices......	Relatively high	Generally declining	Lower	Slowly advancing
Prices of old bonds with fixed yields	Fairly low	Slowly advancing	Fairly high	Slowly declining
Prices of stocks...............	High	Falling rapidly	Low	Low, then recovering
Dividends and business profits...	Large	Decreasing	Small	Slowly increasing
Interest rates on new investments	Rising	High	Fairly low, few issues	Gradually advancing
Speculation in commodities and securities	Extensive	Diminishing	Very little	Slowly increasing
Bank clearings................	Large in volume	Shrinking in volume	Small	Gradually increasing in volume
Business failure...............	Few	Rapidly increasing	Fairly large	Fewer and fewer
Psychological factor............	Bold action and optimism	Fear	Pessimism	Caution and timidity

but as loans are gradually repaid and further loans and discounts decline, deposits tend to become less and reserves greater. Interest rates on short-term loans are gradually lowered as funds become more abundant. The prices of securities yielding a fixed rate of interest tend to advance, while the market prices of shares of common stock remain relatively low. Imports decline while the prevailing low prices of many products tend to stimulate exports. New enterprises and industrial expansions are not undertaken to any great extent during the period of depression, since the possibility of profits is too uncertain.

d. Recovery. The shortage of some basic commodities, however, eventually inaugurates a slow upward movement in the prices of these products. This, in turn, stimulates an effective demand for other commodities, and so the physical volume of production tends to increase again. Trade expands more and more, which is reflected in increased bank clearings, the larger volume of railroad traffic, and similar indices. Unemployment decreases as factories that have been shut down or working on part time take on new help.

During the period of recovery, bank loans and discounts slowly increase with the expanding volume of production and trade. But interest rates on commercial loans are low because of the abundance of loanable bank credit. Activity in the security market is gradually resumed; stock prices, many of which are relatively low, begin to rise again, while bond prices remain fairly high for the time being. With better prospects of profits, activity in the stock market increases, as is evidenced by the increased volume of securities traded.

e. Summary. The characteristic conditions ordinarily prevailing in each phase of the business cycle are summarized in Table 5.

10-4. New Features of the Prosperity of the Twenties. The characteristic conditions in the several phases of the business cycle were modified somewhat by the peculiar industrial and financial developments in the United States after 1922. These modifications have been suggested from time to time in the preceding discussion of monetary and banking problems. In view of the importance attached to them by various observers prior to 1929, who interpreted them as indications that a new era had dawned in our capitalistic economy and that the business cycle had been "ironed out," they are here summarized briefly.

Whereas former periods of prosperity were usually accompanied by rising commodity prices, the period of prosperity culminating in the security-market collapse in the fall of 1929 was characterized by relative stability in commodity prices. Speculation in commodities, in anticipation of advancing prices, was almost nonexistent. The most striking exception was the rapid advance in the price of copper in 1928 and 1929.

But the inflation of stock prices more than made up for the absence of commodity-price inflation. Industrial funds, which in former periods of prosperity were invested in commodity inventories with a view to their profitable employment, in 1928 and 1929 frequently found their way into the call-loan market to take advantage of the prevailing high money rates.

Again, earnings in industry were growing, not because of advancing commodity prices, but rather because of economies in production and widened markets. Earnings were augmented by a liberal extension of foreign credits and an expansion of consumers' credit in the form of installment sales.

Furthermore, commercial-bank credit, which during former periods of prosperity was generally expanded to the limit of legal-reserve requirements at the time of the crisis, was more than adequate to accommodate business in the late fall of 1929.

During former periods of prosperity, employment was abundant and increased with expanding production, while the prosperity wave of the twenties was characterized by an increasing volume of production without a corresponding increase in the number of those gainfully employed. Whereas 9,000,000 factory workers were employed in the United States in 1919, the total number of factory wage earners in 1929 was 8,550,000. Improvements in the arts of production and the introduction of modern mechanical devices were reflected in so-called "technological unemployment" in many industries. Money wages were not advancing as rapidly as during former periods of prosperity, but in view of the relative stability in the purchasing power of the dollar from 1922 to 1929, increases in money wages, where they did occur, represented increments in real wages.

The prosperity wave of the late twenties, however, was distinctly spotty. Agriculture was not able to recover from the severe setback it had received in 1920; it continued in the throes of an almost chronic depression until 1933, when prices collapsed so that the drastic recovery measures were inaugurated by the Federal government.[1]

The distinctive characteristics of the period of growing prosperity, terminating in 1929, were scarcely sufficient to warrant the conclusion that the business cycle was no more. They represented new or modified business indicators, whose real significance and weight were misinterpreted by many of the new-era spokesmen. But they were sufficiently unique and striking to merit the serious consideration of all observers of business phenomena.

10-5. Price Levels and the Business Cycle. Cyclical movements in business activity prior to 1922 were usually accompanied by characteristic changes in the general level of prices. During the period of business recovery, prices tended to advance, reaching a high point during the period of prosperity, then declining until they fell to a relatively low level during the period of industrial depression. These cyclical price changes should be differentiated not only from seasonal variations in the prices of particular commodities, but also from the gradual, long-run changes in the level of prices, known as the secular trend.

Cyclical price changes were never the same for all commodities. The prices of some commodities and services advanced more rapidly than the prices of others during periods of recovery and prosperity, not only because of the habitual aversion of the consuming public to higher prices, but also

[1] See Chap. XX.

because of public control exercised over prices charged by public-service enterprises.

Finally, as previously shown, commodity-price changes and cyclical movements in industrial activity are not necessarily related phenomena, even though often associated in the past. The business cycle is much more than a series of price changes. It may be viewed as a characteristic feature of the capitalistic system. Again, periodic fluctuations may ultimately be found to reflect the emotional cycles of man himself. Every phase of industrial life—the physical volume of production, business profits, investments, wages, interest, etc.—is affected in one way or another in the course of the business cycle. Some of the many attempts at explanations of business cycles will serve to illustrate the many causal factors of business cycles that have been advanced by students of the subject.

10–6. Explanations of Business Cycles. *a. Natural-phenomena or Physical-cause Theories.* Some writers have sought the cause of the periodic recurrence of prosperity and depression in phenomena of nature. The first of this group was the English economist William Jevons, who advanced the theory that the disturbances on the sun, known as sun spots, occurred in 10-year cycles, and that these cyclical recurrences caused corresponding cycles of climatic conditions on the earth. These atmospheric disturbances, in turn, affected crops, causing periods of business prosperity and depression, owing to the interdependence of agriculture and industry. This theory, however, assumes a regularity of recurrent phases of the business cycle that does not exist.

Subsequently, H. L. Moore showed that rainfall in the Ohio Valley occurs in 8-year cycles, and combined his observation with the cyclical movement of business. He held that the 8-year cycles of rainfall generated crop cycles, which in turn caused cyclical activity in industry.

Both the "sun-spot" and the "rainfall" theories of business cycles are open to the objection that they exaggerate the regularity of recurring phases of prosperity and depression. Moreover, agriculture is not so dominant an element in the economic situation today as it was formerly.

b. Overproduction or Underconsumption Theories. Some theorists ascribe the ultimate cause of the business cycle to inherent defects in our present competitive system of capitalistic production. The Marxian socialists, for example, hold that the search for profits causes periodic overproduction. The inability to consume all the goods produced causes periodic gluts of the market, when production slows down to allow consumption to catch up. The overproduction and underconsumption theories are two different aspects of the same idea. They trace the alleged overproduction to the inequalities of income distribution in capitalistic countries, which lead to excessive savings and investments on the part of larger income recipients.

Since so large a share of the national income goes to the owners of wealth, it is argued, they are unable to spend it all for consumers' goods. They therefore invest their surplus income more and more in the further production of capital goods, which makes possible increasing the output of consumers' goods. But since wage earners receive an inadequate share of the national income, they are unable to buy the increasing supply of consumers' goods. Thus there is a constant tendency for production to outrun consumption. The cumulative excess of production gradually leads to congested markets. Consequently, production is curtailed, unemployment increases, prices are lowered to dispose of surplus consumers' goods, profits diminish, and a period of depression sets in.

As prices are cut and production is retarded, the reduction of incomes of the owners of wealth results in diminished savings and decreased new investments in capital goods. Gradually, however, consumption catches up with productive capacity, prices begin to rise, and prospects of profits become favorable once more. Sooner or later a disproportionately large share of the national income will again go to owners of wealth, savings and new investments will expand, and another period of overproduction will be inaugurated.

There may, indeed, be misdirected production and inequitable distribution of the national income. But this can scarcely be called general overproduction. Oversupply should not be confused with overproduction. The former condition exists when goods have been produced that cannot be sold to yield a normal rate of profit. They thus tend to glut the market and depress business. Overproduction, on the other hand, implies the making of goods that are not wanted. This is in reality a contradiction in terms, for production, in the economic sense of that word, is the creation of want satisfaction in economic goods. To make things no one wanted would not be production but waste of productive resources.

One of the causes of the business cycle may be found in a recurrent maladjustment in the balance between the production of producers' goods and consumers' goods, or of particular goods within either or both groups. But this is misdirected production and not overproduction.

c. Overinvestment Theory. While underconsumption theorists attribute business cycles to oversaving growing primarily out of inequalities of income distribution, the overinvestment theorists of business cycles maintain that private investment of loan funds periodically tends to outrun voluntary saving. In early stages of business recovery, bank reserves are disproportionately large. To encourage borrowing, banks lower the market rate of interest; and since banks, as a group, can expand the supply of loan funds in excess of their holdings of cash reserves, they can increase the supply of loanable funds beyond those voluntarily saved and invested by income recipients. This augmented supply of loan funds keeps the market

rate of interest below the normal rate, which would equate voluntary saving and investment. The resultant lower cost of loan funds to business gives an artificial stimulus to profitable investment and so induces business expansion.

As long as the new loan funds provided by banks keep the market rate below the normal rate of interest, business will expand investment, while with rising prices of consumers' goods induced by expanding earnings, many consumers will be compelled to save involuntarily. This situation, however, cannot continue indefinitely. Sooner or later banks will reach the legal limits in their expansion of bank credit. As the market rate of interest is raised with growing scarcity of new loan funds provided by banks, prospects of continued profitable investment diminish. Moreover, some investment projects begun at an earlier period may become increasingly costly to complete. Voluntary savings, in the face of rising prices of consumers' goods, are found inadequate to purchase the investment securities initially financed with the aid of bank funds unless the interest rates are increased.

Furthermore, the increased supply of loan funds, augmented by banks during the upswing in the cycle, has increased consumer incomes in the form of increased payrolls, etc. This, in turn, has stimulated the demand for consumers' goods, and sooner or later competition for the factors of production between producers'- and consumers'-goods industries will also exert an upward pressure on the costs of capital goods production. The cumulative effects of overinvestment, artificially induced with the aid of relatively cheap loan funds, thus eventually leads to a condition that cannot be maintained. The period of prosperity ends, business declines, and deflation of bank credit with accompanying underinvestment culminates in business depression. Overinvestment theorists thus ascribe the chief generating factor of business cycles to the disparity in the market and normal (or pure) rates of interest, made possible because the banking system can expand and contract the supply of loan funds. Many economists lean heavily toward the acceptance of the overinvestment theory as an important explanation of business cycles. In consequence, they also view effective control over the supply of bank credit as an appropriate means of controlling business cycles.

d. Capitalization Theories. It has been suggested by some writers that business crises are brought about by the mistaken capitalization of the productive agents. In our present capitalistic system production is carried on largely in anticipation of demand, and the value of durable capital goods, industrial plants, and equipment is based more on anticipated than on actual income. The amount of this anticipated income is largely a matter of conjecture. Because of mistaken estimates of these future values, as reflected in maladjustments of industrial capitalization, constant revalua-

tions of sources of income are necessary. As long as private investment continues, and men are guided in their investment activities not so much by their own judgment as by the example set by others, the "hypnotism of the masses" will continue to be an important psychological factor in determining the capitalization of industry. The recurring maladjustments in the capitalization of industrial enterprises have constantly necessitated readjustments in market values that have often undermined confidence and precipitated industrial crises.

e. Self-generating Theory. The advocates of self-generating theories maintain that each phase of the business cycle is generated by conditions that have developed in the preceding phases. Assuming an adequate supply of loan funds, a period of prosperity will follow a period of recovery induced by too rapid an expansion of debts; and when the supply of credit is exhausted, a crisis will follow a period of prosperity, which will, in turn, introduce the liquidation phase. Proponents of self-generating explanations of business cycles begin their explanation of the business cycle with an analysis of conditions prevailing in one of the phases of the cycle, and indicate how these conditions generate the following phase.

In the words of Wesley C. Mitchell, a leading exponent of the self-generating theory,

> The recurrent phases presented by economic activity, whenever it is dominated by the quest of profits, grow out of, and grow into another. An incipient revival of activity, for example, develops into full prosperity; prosperity gradually breeds crisis; the crisis merges into depression; depression becomes deeper for a while, but ultimately engenders a fresh revival of activity which is the beginning of another cycle.[1]

Thus, self-generating theorists regard the explanation of the business cycle as a descriptive analysis of cumulative changes by which one set of business conditions grows into another. Implicit in their theory is the basic concept of the business cycle as inherent in any private competitive economy. In other words, capitalism can never rid itself of business cycles so long as it survives as capitalism.

It is doubtful whether any one factor can be singled out as being the sole generating or primal cause of the intermittent recurrence of periods of business prosperity and depression. Economists are inclined to accept the causal sequence or self-generating explanation of business cycles, which discovers in each phase the essential conditions out of which the succeeding phase develops.

10–7. Depression of the Thirties. *a. Significant Characteristics.* Did the depression beginning in 1929 show the typical characteristics of former periods of depression? In general, this question may be answered in the

[1] "Business Cycles," p. 449.

affirmative. But there were certain aspects of the depression of the thirties that were unique. In the first place, its intensity, as well as its duration, was greater than any other depression in the history of the nation (see Chart 5, p. 188). Secondly, it was almost universal. It hit practically all commercial and industrial countries of the world with varying degrees of severity. In the third place, it was not preceded by a period of rising commodity prices. The wholesale-commodity-price index remained fairly constant from 1922 to 1929. This, as previously shown, led many to believe that a new era of stabilized prosperity had been inaugurated.

The many changes in the traditional gold standard after the First World War resulted in increasing the available monetary reserves in various countries. Gold had been largely withdrawn from circulation and added to monetary reserves. Moreover, these reserves had been redistributed throughout the world as a result of the abnormal trade conditions brought about by war. For example, in 1913 the United States had about 25 per cent of the world's monetary stock of gold; in 1932, this had increased to nearly 40 per cent.

On the basis of these expanded gold reserves it was possible to erect an abnormally large credit structure, which was reflected not merely in the large foreign public and private loans floated in the United States during and after the First World War but also in the liberal expansion of domestic credits.

The extensive international expansion of credit, as well as the adoption of the gold-exchange standard by a number of countries prior to 1929, tended to knit the nations of the world closer together in their financial and monetary arrangements. On the other hand, prompted by a desire for self-sufficiency and by an exalted spirit of nationalism, governments built up trade barriers in the form of tariff restrictions, embargoes, exchange control, and import quotas, which tended to separate them economically. Sooner or later such an anomalous situation would lead to disaster. The rapid collapse of the credit structure after 1929, nationally as well as internationally, brought on a rapid decline in prices, which, in turn, further aggravated the situation of debtors. As money appreciated in value, *i.e.*, as prices declined, the real burden of debts in terms of goods became unbearable.

It is difficult to decide, in the causal sequence of events, which were the basic factors that made for the contraction of credit beginning in the fall of 1929. The stock-market crash was itself the climax of conditions that had preceded it. The rise in stock prices had reflected the increasing profits of many American corporations during the twenties, which speculative buyers of securities apparently expected would continue indefinitely. It has been facetiously remarked that people were discounting not merely the future but also the hereafter. One may attribute the sudden con-

traction of credit to a sharp curtailment of the investment process just prior to 1929, which decreased currency circulation, employment, and consumption. Again, one may hold it to have been caused by overspeculation, culminating in a natural reaction. It may also be argued that the maldistribution of the world supply of gold after the First World War or the inadequacy of this supply to support our inflated credit structure was the fundamental reason for collapse.[1]

b. Extent of Deflation, 1929 to 1933. Whatever factors may be regarded as the basic causes of the sudden wave of liquidation and deflation, beginning in the fall of 1929, its effects were distinctly cumulative. The money value of the national income produced began to contract rapidly. In 1929 it was placed at 83 billion dollars, while in 1933 it had decreased to around 40 billion dollars, or slightly more than half. Such a pronounced decline in the national income meant a decided curtailment in the consumption and production of goods. But it should be borne in mind that a 52 per cent shrinkage in the value of the income of the people in the United States between 1929 and 1933 did not mean a corresponding decrease in physical production and actual consumption, for the cost of living declined about 25 per cent during this same period. Nevertheless, decreased domestic consumption, accompanied by a pronounced shrinkage in export trade, created the appearance of overproduction in many branches of industry. While the Federal Reserve Board's index of industrial production declined from 119 in 1929 to 76 in 1933, or by 36 per cent, the index of stocks of manufactured goods and raw materials in the United States, compiled by the Department of Commerce, actually rose from 137 in 1929 to 148 in 1933, or by 8 per cent.

Confronted with unsalable goods at prices sufficient to cover costs, many industries continued to curtail their production programs. This, in turn, meant further decreases in employment and continued lowering of incomes. The index of employment, computed by the Bureau of Labor Statistics, declined from 97.5 in 1929 to 56.4 in the first quarter of 1933 (using 1926 as the base year), while the pay-roll index decreased from 100.5 to 35.2 during the same interval.

c. Failure of Natural Economic Forces of Recovery. It seemed impossible to break through the vicious circle of credit contraction, declining prices, decreased consumption, growing unemployment, and curtailment of production. The economic depression in the thirties passed what some people regarded as the point of natural rebound, beyond which the traditional forces and methods of economic recovery were no longer effective. The dollar debt structure, which had been erected during previous years of prosperity in terms of relatively low-valued dollars, was too heavy to bear

[1] For an illuminating discussion of this question see J. M. Clark, "Strategic Factors in the Business Cycle," particularly Parts III and IV.

when repayment was required in dollars whose purchasing power had risen some 65 per cent at wholesale between 1929 and 1933.

In former depressions, values had been readjusted downward through foreclosures, reorganizations, and forced liquidations, until conditions for recovery were satisfactory at lower levels of costs and prices. Prices of goods that could not be sold at their estimated values had been cut to a figure that would sell them. Property that could not pay interest on its mortgage had changed hands, passing into the possession of those who could "carry it" at a lower value. Issuers of bonds who could not pay their interest had to pass through a process of reorganization aimed at a reduction of their fixed charges, or possibly transfer ownership. After reorganization, the bond issuer might then, with good management, expect to obtain enough income to pay his interest charges. The result was a readjustment of values that enabled the financial organism to resume its performance of the old functions upon a revised and more realistic basis of relationship between borrower and lender, producer and consumer, costs and prices.

But the magnitude of the debts existing in 1933 was too great for a deflated economic structure to bear. Total net public and private long- and short-term debts in the United States amounted to nearly 150 billion dollars in 1933. Of this total, 37.8 billion dollars or 25 per cent represented public or governmental debt, while 111.6 billion dollars or 75 per cent was private indebtedness. Interest and debt repayments on these obligations became increasingly burdensome with the decline in the price level during the early thirties. This price decline, brought about primarily by the excessive contraction of credit currency and the pronounced retardation in the velocity of monetary circulation, necessitated drastic measures to prevent its continuance. Strenuous measures had to be taken to stem the tide of deflation.

10–8. Efforts at Governmentally Guided Recovery. The Democratic administration, which took office in March, 1933, inaugurated numerous measures intended to stimulate economic recovery and to prevent further price deflation. Reference has been made previously to the monetary and banking legislation of 1933–1934. But in addition to these laws a number of other positive measures were adopted, with a view to furthering economic recovery. Foremost among these was the National Industrial Recovery Act of 1933. This act marked a distinct departure from the traditional methods of achieving recovery after periods of business depression through the automatic operation of natural forces; it was popularly heralded as inaugurating planned recovery and a "New Deal."

10–9. National Industrial Recovery Act. This law authorized the President of the United States to establish the necessary facilities to organize industry under codes of fair competition. Under the act industries were

permitted to submit voluntary codes for their guidance or the President might formulate codes for them. Failure to follow regulations imposed under codes would result in refusal or loss of license to operate. Membership in codes was extended freely on equal terms to all those engaged in a particular trade or industry.

Although the act provided that no monopolies should be created, codified industries were nevertheless relieved of the restrictions of antitrust laws. It did not provide for fixing prices directly; but indirect control over prices, through production control as well as minimum wage and maximum working-hour requirements, was apparently one of the underlying purposes of the National Industrial Recovery Act. The labor provisions of the National Industrial Recovery Act were particularly significant. Employees were given the right to organize and bargain collectively through representatives of their own choosing; they were not required to join company unions as a condition of employment. The President, however, exercising the power vested in him under the act, required that all approved industrial codes should declare against child labor as constituting unfair competition.

In 1935, the United States Supreme Court handed down a unanimous decision,[1] declaring unconstitutional Section 3 of the National Industrial Recovery Act. This section embodied the provisions governing the code-making authority and the fixing of hours and wages.

The Court decision meant a decided setback to the whole program of planned recovery inaugurated by the Democratic administration in 1933. Official steps were taken, however, to continue the National Recovery Administration in skeletonized form, in order to bring together and summarize the large body of information gathered by the Recovery Administration during its nearly two years of existence.

10–10. Some Problems Arising Out of Federal Efforts at Governmentally Guided Recovery. The idea of coordinating business in industrial and trade groups along cooperative lines was stamped by some critics as a big step toward socialism. Without questioning the motives that prompted the program of planned recovery under industrial codes, it is very debatable whether the methods employed either accelerated or retarded recovery. Underlying the recovery program, there were, however, certain fundamental economic issues that should be borne in mind.

a. Repression of Profits Motive. As long as an individualistic competitive economic system prevails, in which the motivating force to business enterprise is the quest for profits, it is difficult to see how a program that raised production costs and diminished possibilities of profits could be relied on to stimulate economic recovery.

[1] *A.L.A. Schechter Poultry Corporation et al. v. United States of America,* 295 U.S. 495 (1935).

"Under the new conditions," said Leonard Ayres, "the business man must first advance the funds to employ more workers and pay them higher wages, and then hope that the increased purchasing power thus released will stimulate sufficient volume of buying, despite higher prices, to make a profit margin possible."[1] This seemed to be putting the cart before the horse, for, in a private-enterprise economy, the prospect of profitable investment had hitherto been a basic requisite for actual economic recovery. Underlying the recovery program was the implied assumption that business leaders had changed their traditional motivation for engaging in business and were willing to sacrifice profits for some time to come in order to increase the purchasing power of the great masses of consumers.

b. Adjustment of Production to Demand. The suggestion that production should be adjusted to demand was frequently made in connection with the recovery program. Adjustment, in this respect, was widely regarded as meaning curtailment. But real demand grows out of production, and curtailment of production, therefore, is synonymous with reducing real demand. To be sure, there may be overproduction of specific products, which would normally be reflected in declining prices of such products, relative to the prices of other goods. But the codified industries endeavored to maintain prices, and even to raise them. To do this, it was felt that further restriction of output would be necessary, with a view to adjusting production to demand. This procedure has been facetiously called an attempt to "stabilize poverty."

c. Rigidity of Costs of Production. The idea of fair competition, which was stressed in the codes, was commonly interpreted to mean not to sell below costs of production, and, in general, not to indulge in unfair business practices. In the first 200 codes approved by the National Recovery Administration, the provision that selling below costs constitutes an unfair trade practice occurred no less than 146 times.[2]

Selling below "costs of production," as an indicator of unfair competition, raised some difficult questions. What should be included in costs of production? Whose costs should be used as a standard? At what percentage of plant capacity should costs be established? What basing point should be selected for cost determination? How should administrative and marketing costs be handled? How should joint costs be allocated among individual items? How should overhead costs be distributed? How would it be possible to maintain assumed cost-of-production prices if demand for products changed? These questions arose out of the suggestion that "costs of production" should be made the guide to fair competition. Setting up some arbitrary cost-price standard as a basis for

[1] "The Economics of Recovery," p. 143, The Macmillan Company, New York, 1933.

[2] FILENE, LINCOLN, "Unfair Trade Practices," p. 133, Harper & Brothers, New York, 1934.

fair competition would tend to increase the rigidity of the price structure and, if continued, would eventually spell the doom of the traditional competitive system in which prices adjust themselves under private enterprise to changing conditions of supply and demand.

But it is possible to establish standards of fair trade practices as bases for fair competition. Secret rebates, discrimination, misrepresentation, price cutting, false and misleading advertising, bribery, intimidation, and exploitation are all practices that are generally recognized as indicative of unfair competition. To the extent that the industrial codes diminished such unsound and unethical practices in business, they made a positive contribution to the raising of business standards. But, in the last analysis, it is not the formulating or codifying of fair business practices that really counts. It is adhering to such ethical standards on the part of business enterprisers that must determine their ultimate effectiveness.

10–11. What Did Guided Recovery Accomplish? What was achieved by the recovery program of the New Deal? An authoritative answer cannot be given to this question, for it will continue to be a partisan question for many years. Nor can the various measures adopted by the Federal government to aid recovery be evaluated separately. The Federal monetary and banking legislation, previously discussed, was directed toward expanding credit and raising prices, while the Agricultural Adjustment Act of 1933 aimed at a redistribution of the national income by increasing the prices of farm products relative to the prices of industrial products.

Moreover, the program of public and civil works inaugurated by the Federal government in 1933 inevitably reacted upon many branches of private enterprise. Under the National Industrial Recovery Act the sum of 3.3 billion dollars was appropriated to carry out numerous public and civil-works projects under the Federal Emergency Administration of Public Works, created by the President. To the extent that these Federal funds were made available out of loans to employ labor in various public and civil projects, they aided in stimulating consumption. Such increased consumption, in turn, enhanced the prospects of wider sales and higher prices and served as an incentive to expand private production.

Whether a more extensive program of public works, financed by government deficit spending after 1933, would have stimulated economic recovery and restored prosperity is a debatable question. The fact remains that, as previously noted, in spite of partial recovery in 1934 and again after the recession of 1937, full recovery and reemployment of idle productive resources were not achieved in our economy until we embarked on the defense program in 1940. With accelerated governmental production of war goods, financed with the aid of large loan funds, the depression was finally ended by world catastrophe, rather than by national peacetime planning. It is a moot question whether the losses in our economy during

the war exceeded or fell short of the costs of the depression of the thirties. These depression wastes have been variously estimated at several hundred billion dollars of potential national income lost owing to involuntary idleness.

10-12. Public Works as an Aid to Recovery. An extensive forward-planned program of public works to alleviate unemployment in periods of depression has frequently been proposed in the past. These public works were to be begun as soon as certain indices of business conditions, such as industrial production, employment, and prices, revealed a distinct falling off in private business activity.

Experience during the thirties showed that the effectiveness of such a program for a reserve of public works, as a means of counteracting business fluctuations, depends upon a great variety of factors. Unless the scope of public improvements in reserve is adequate to absorb idle labor, where such labor is available, its effect may be negligible. Furthermore, to assure prompt action, Federal, state, and local governments must have appropriations of public funds available and must be ready to award contracts for the work without delay. Again, public credit facilities, in the form of legal borrowing capacity, must be provided for in advance. The absence of political interference with the operation of the proposed reserve of public works must also be assured. Finally, provision must be made to discontinue public works when private business has sufficiently recovered to utilize the available labor supply. This may prove both inexpedient and costly, if not impossible, for many public improvements, *e.g.*, Boulder Dam, require years for their completion. A reserve of public works can thus be viewed as a palliative, rather than as a remedy, of business fluctuations. In our postwar economy, governments, whether at the Federal, state, or local level, are apparently planning to use forward-planned public works as a major weapon, designed to stabilize production, employment, and income.

10-13. Employment Act of 1946. After the close of the Second World War Federal legislation was considered that, if enacted, would have established a national policy of guaranteeing continuous "full employment." Not only fear of mass unemployment in the transitional period from a wartime to a peacetime economy, but also, in view of historical precedent, the desire to forestall a major postwar depression by governmental action prompted the proposal.

The expression "full employment," used extensively to indicate the major objective of our peacetime economy, may be variously interpreted. It has been defined "as a condition under which every person who is able and willing to work can find enough employment in the course of a year to earn not less than enough to maintain his habitual standard of living." [1] The

[1] GOLDENWEISER, E. A., "Postwar Economic Studies," No. 1, p. 4; Board of Governors of the Federal Reserve System, Washington, D. C., 1945.

expression may be used to indicate providing "jobs for all," *i.e.*, all seeking employment at prevailing wage rates; or, providing work for the involuntarily idle at wage rates arbitrarily set by the government.

In view of the many varieties of involuntary idleness, such as seasonal, cyclical, technological, and frictional, it is obviously necessary to decide which type or types of unemployment the government would seek to eliminate.

After lengthy debate, Congress passed the Employment Act of 1946, which declared it to be "the continuing policy and responsibility of the Federal Government to use all practicable means" in conjunction with private enterprise and state and local governments, to coordinate and use its resources in a manner calculated to foster and promote free competition, enterprise, and the general welfare, and "to promote maximum employment, production and purchasing power."

The President was required under the act to submit to each session of Congress an economic report, setting forth the levels of employment, production, and purchasing power obtaining in the United States and such levels as needed to carry out the above policy. Moreover, he must prepare a program for carrying out this policy. Significantly, the act used the words "program" and "policy," rather than the word "planning." The three presidential advisers provided for in the act have the duty to develop and recommend to the President national economic policies designed to foster free competitive enterprise, to avoid economic fluctuations or to diminish the effects thereof, and to maintain "employment, production and purchasing power."

Since business cycles have come to be viewed as a characteristic of a capitalistic system, based on the principle of active competition, one may seriously question the possibility of formulating a governmental policy designed to foster free competitive enterprise and at the same time to avoid economic fluctuations. In the light of historic reality these appear to be incompatible objectives. But public policy can and should be directed toward diminishing the effects of economic fluctuations by adopting measures that will alleviate conditions of cyclical unemployment in our economy. A forward-planned program of useful public works has come to be viewed as a major weapon of government to aid in combating such involuntary idleness. It is obviously illogical to defer preparing such a program until a depression is upon us. Planning to meet conditions of economic depression should properly be done in advance during periods of prosperity.

10–14. Integration of Public and Private Enterprise. The extension of direct productive activity by governments in our postwar economy with a view to achieving a higher degree of economic stability than in the past will, of necessity, result in increasing governmental encroachment upon

many traditional fields of private competitive enterprise. The expansion of public-housing projects is a case in point. Public housing has come to be viewed by many as a major field for the expansion of public enterprise in the postwar era.

What will be the effects of this expanding economic activity of governments on our traditional attitude toward free private enterprise? Basic motivations of private and public enterprise are essentially different; the one is economic, the other is sociopolitical; the one is individualistic, the other is collectivistic; the one is guided by the quest for profits, the other by the avowed desire to promote the public welfare.

Many critics have viewed the expansion of public enterprise for the purpose of achieving stability of production and employment as incompatible with our private-enterprise economy. They hold that it will eventually necessitate a choice between either a governmentally controlled economic order, directed by political authority, or a system based on free private enterprise, in which government acts merely as umpire to see that the rules of the game of business are observed.

Much study and serious thought will be required before we shall have developed the functioning mechanism of a stabilized economic system. Some economists have questioned the desirability of business stability, even if it could be realized within the framework of capitalism. They hold that recurring business depressions after periods of prosperity are indicative of a dynamic economic order, involving constant change. During periods of depression, many failures occur—the weaker enterprises are weeded out and the stronger survive. Thus, much obsolete and useless equipment finds its way to the scrap heap, while room is made for new technical appliances and new investment of savings, contributing to increased production at lower unit costs.

Those who support this viewpoint would rely on free competition to achieve the goal of high levels of production. They seemingly fail to recognize the trend toward increasingly imperfect and monopolistic competition in our economy, which has contributed to accentuating economic instability. In spite of this trend, the Employment Act of 1946 makes it a matter of public policy to foster free competitive enterprise. But the act also recognizes the need for a public policy that will coordinate the resources of the government with private enterprise, with a view to promoting maximum employment, production, and purchasing power. This latter objective, if it is to be realized, will necessitate the effective integration of public and private enterprise so as to counteract the economically injurious effects of business depressions.

Reasonable economic stability at high levels of productive employment has come to be viewed as the major goal of our peacetime economy. Even though one may subscribe wholeheartedly to a realization of this goal, one

should not lose sight of the changes in our traditional economic institutions and habits of thinking on economic matters that will be necessary if we would attain this objective. These issues will be analyzed in subsequent chapters dealing with governmental fiscal policies aimed at greater economic stability and less economic inequality. Answers to some questions raised here concerning unfair trade practices, costs, prices, and rates will be attempted also in a later part devoted to industrial monopolies and public utilities.

Guide Questions on Text

1. What is meant by business cycles?
2. Trace the history of the various business crises experienced by the United States since 1800.
3. Business cycles are commonly divided into a number of distinct phases. What are these phases?
4. Indicate the significant characteristics of each phase.
5. What were the unusual features revealed during the prosperity period of the twenties?
6. Did these unusual features of the prosperity period warrant the conclusion that business cycles had been "ironed out"? Give reasons for your viewpoint.
7. "Cyclical price changes should be differentiated from secular price changes, both as to causes and as to effects." Explain.
8. Evaluate critically the natural-phenomena theories of business cycles.
9. Criticize the overproduction theories of business cycles.
10. What is meant by the self-generating theory of business cycles?
11. Contrast the underconsumption theory with the overinvestment theory of business cycles.
12. Business cycles have been ascribed to "mistaken capitalization of the productive agents." Explain.
13. In what important respects did the depression of the thirties differ from earlier depressions of our history?
14. Why did recovery not follow the depression of the early thirties, in accordance with the traditional cyclical pattern?
15. Evaluate critically the efforts of the Federal government to induce recovery after 1933.
16. What was the theory behind the government's plan to stimulate recovery, in accordance with provisions of the National Industrial Recovery Act?
17. Criticize the frequently heard statement that, in order to maintain stability in our economy, we must "adjust production to demand."
18. What are the obstacles to adjusting production costs to selling prices in a period of business recession?
19. What did planned recovery under the emergency legislation of the New Deal accomplish?
20. In how far, if at all, may a forward-planned program of public works aid in stimulating recovery?
21. Evaluate critically the Employment Act of 1946.
22. What are the economic problems arising out of the efforts to integrate public and private enterprise as a means to stabilize high levels of productive employment?
23. Criticize the contention that business stability is not necessarily desirable, even if it could be achieved.

Topics for Investigation

1. Effects of business cycles on the pattern of income distribution.
2. Public works policy as means of alleviating business depressions.
3. Government fiscal policy and business cycles.
4. Theoretical considerations of governmental deficit spending as an aid to business recovery.
5. Changing attitudes toward alleviating business depressions.
6. Monetary policy and business cycles.

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Part Four

PROBLEMS OF INTERNATIONAL EXCHANGE

CHAPTER XI

INTERNATIONAL TRADE AND FOREIGN EXCHANGE

11–1. Private and Public Aspects. Before considering economic problems arising out of the intricate commercial relations among various trading countries, the basic characteristics of international trade will be reviewed briefly. International trade consists basically of an exchange of commodities and services among private business units located in different countries although at times governmental agencies carry on trade directly. During the First World War, for example, the United States government made extensive loans to the Allied governments, with the proceeds of which these governments purchased materials from private business units in the United States. Again, in the Second World War, governmental agencies exchanged war supplies and materials among the Allied powers under Lend-Lease and reverse lend-lease arrangements in accordance with the provisions of the Lend-Lease Act of 1941. But governmental loans to our allies were discontinued shortly after the close of the First World War and Lend-Lease similarly was promptly terminated by executive order at the end of the Second World War. All these governmental transactions in international trade may thus be viewed as emergency measures, dictated by wartime needs. They differ significantly from normal peacetime trade, conducted by private trading units on a commercial basis in open markets.

But even in peacetime governments have aided private enterprise in financing international trade by extending or guaranteeing credits, while the actual trade has been carried on by private agencies. For example, two Federal export-import banks were created in the United States in 1934 to help finance exports and imports between the United States and other nations. Governments have also sought to stimulate exports of various types by subsidies and bounties. Moreover, some governments have promoted trade between their nationals and the Soviet Union by guaranteeing a portion of the credits extended by their exporters. Only in the Soviet Union, however, is foreign trade a state monopoly. Article One of a decree issued by the then Bolshevik government on Apr. 22, 1918, reads as follows:

> The entire foreign trade is nationalized. Commercial transactions in all goods whatsoever . . . to and from foreign states and individual trade enterprises are

to be effected on behalf of the Russian Republic by organizations authorized for this purpose. Any imports and exports through channels other than these enterprises are prohibited.

11–2. Similarities between Domestic and International Trade. *a. Division of Labor and Mutuality of Interest.* The underlying principles of international trade and domestic trade are essentially the same. The expression "interregional trade," pertaining to trade within and across national boundaries, has found wide usage in economic literature. It suggests the similarities between all trade, regardless of political frontiers. Fundamentally, trade consists of an exchange of goods for goods, including in the concept "goods" both commodities and services. Basic to the exchange of goods is division of labor or specialization. Furthermore, all trade, whether domestic or international, is carried on for mutual gain and benefit. We produce and sell goods in order that we may buy other goods in exchange.

The extent to which we are able to sell depends not only on our productivity, which measures the size of our salable surpluses, but also on our ability to find markets or to create markets for the products we wish to sell. On the other hand, we are able to buy products to gratify our desires to the extent that we are able to sell our own products. We produce in order that we may consume, and the volume of available consumable goods is limited by the amount we have produced. Moreover, we cannot buy unless we sell, and we cannot sell unless we buy, for, strictly speaking, we sell funds, whether money or credit, whenever we employ them to buy economic goods. This principle of mutuality or reciprocity is fundamental in both international and domestic trade.

b. Complications of Money and Nationalism. The use of money as a medium of exchange has somewhat beclouded the real nature of exchange transactions. A person looks upon the purchase of an article with money, whether at home or abroad, as a complete exchange transaction. It is a completed money or commercial transaction, but an economic or real exchange is completed only when goods have been exchanged for money or credit and the money or credit has again been exchanged for goods. Full recognition of this fact will help to clarify many popular misconceptions pertaining to foreign exchange, international trade, and foreign investments.

Moreover, the grouping of peoples into sovereign states and nations, each politically independent of the other, has led to the popular misconception that economic interests and political boundaries are coextensive; or, rather, that political boundaries terminate the mutuality of economic interests between peoples. As a result, international trade has come to be regarded with suspicion and as an economic process very different from domestic trade. It is popularly believed that a nation benefits by its ex-

ports and suffers by its imports; an unfavorable trade balance is often viewed with apprehension. This misunderstanding can be clarified only by realizing that in every exchange transaction he who buys also sells, and he who sells also buys. Again, each exchange is made because both buyer and seller hope to realize benefit by trading a plentiful good for a relatively scarce one, but the net economic gain accrues to the trader in his capacity as buyer rather than as seller. Normally one values that which he gets or buys more than that which he gives up or sells.

11–3. Differences between Domestic and International Trade. There are, however, several differences between domestic and international trade that should not be overlooked. They may be viewed as differences in degree rather than differences in kind. In the first place, various countries have their own monetary units, in terms of which the values of goods are expressed; the monetary units of most countries vary widely in their nature and value. The problem of converting the prices of goods expressed in terms of the monetary unit of one country into other prices expressed in the monetary unit of another country makes the process of international trade more complicated than that of domestic trade.

Secondly, domestic trade is usually free from such obstructions as customs inspection, varying commercial laws, and strange languages, which are frequently of considerable significance in international trade. Tariff regulations and other artificial obstacles hampering international trade are usually absent in domestic trade. Differences in race, nationality, and political affiliation, which affect man's economic conduct, are more significant in international than in domestic trade. The relative immobility of labor and capital plays a more important part in shaping a nation's international trade than its domestic trade.

11–4. Reasons for International Trade. *a. Fact of Geographical Specialization.* As previously stated, all trade, whether internal or across national boundaries, is based on specialization and exchange. One nation may have an advantage over another nation in the production of certain goods because of its control over natural resources, its favorable climatic conditions, its abundant and efficient labor supply, or its accumulation of capital, or because of the impetus of an early start.

These differences in the productivity of the factors of production in various countries will persist; they cannot be overcome by political decrees or legislative enactments. The fact that bananas can be grown more readily in tropical than in temperate climates cannot be altered by placing an import duty on bananas brought into a temperate climate in order to stimulate the raising of bananas there. The fact that highly skilled labor, working with painstaking care, can create artistic products in one country cannot be set aside by arbitrarily enacting laws that prevent the sale of such products in other lands, with a view to developing similarly skilled

labor there. In spite of restrictions and legal barriers, the relative advantages due to the causes cited above will persist.

b. Principle of Comparative Advantage. These relative advantages of different countries in the production of certain commodities, like those of different groups within a country, make exchange mutually profitable. They suggest the guiding principle of international trade commonly spoken of as the "principle of comparative advantage," which may be stated as follows: *Each country tends to produce for export those goods that it can produce most cheaply and tends to import those goods that other countries can produce most cheaply.* Applied to domestic production and exchange, the same doctrine can be stated thus: *Each individual or industrial group within a country tends to produce and sell those products that it can produce most cheaply and buy those products that others can produce most cheaply.*

Thus the close similarity in the underlying principles that apply to both international and domestic trade under competitive conditions may be seen. In the absence of trade restrictions and of hampering legislation, the capital and labor force in each country will tend to be applied to those branches of production where they will yield the maximum product. It has been pointed out that, because of home ties, linguistic barriers, political obstacles, and hampering legislation, labor and capital tend to be less mobile among countries than within a country. Therefore, wider differences in "real" production costs of a larger variety of commodities persist among nations than within any one nation. The greater effectiveness of labor in advanced countries, moreover, will be reflected in higher real wages and higher standards of living than in backward countries. But the larger volume of product resulting from territorial division of labor and the mutual gain from international trade are conducive to raising the real income of all trading countries to relatively higher levels than would be the case without international commerce.

11–5. Mechanism of International Trade. Since peacetime international trade is usually conducted not by governmental agencies but by private persons and business units in search of profits, the problem of making international payments confronts those who buy and sell in the markets of the world.

a. Conversion of Funds from One to Another Currency. When an American manufacturer has discovered a market abroad for his products, he cannot profitably consummate the deal unless he can get something from his customer in exchange that will be worth more to him than what he is selling. His customer abroad will normally not have the exact goods that the American manufacturer wants to barter for the goods he intends to buy. He has purchasing power in terms of monetary units which have general acceptability in his country, but which may lack such acceptability in the United States. The American manufacturer selling his goods

abroad ordinarily wants dollars in payment and not pounds sterling, francs, or kroner.

On the other hand, if his foreign customer is unable to pay him in dollars, but only in the currency of his own country, the American manufacturer and exporter usually wants to be certain that he will be able to obtain a definite number of dollars for the payment he is receiving in foreign currency. Furthermore, the American trader may not be able to wait for weeks or months until his product has been delivered at a distant port to his foreign customer, and then have the agreed-on purchase price sent to him. He may want payment in terms of dollars immediately after he has shipped his goods.

b. Nature and Functions of Bills of Exchange. To meet the need of international traders a third party has been interjected between buyers and sellers in the two countries, one who assumes "the exporter's right against his foreign customers" and who pays the exporter either at once or at a stipulated future time the amount owed him by his foreign customer. This third party is the banker or dealer in foreign exchange.

The instrument by means of which the foreign-exchange banker gives effect to the transfer of goods is a bill of exchange, which may be defined as an order drawn by one party (the exporter) on another (the importer), signed by the party giving it, requiring the person to whom it is addressed to pay a fixed sum of money to the bearer of the order at a stipulated time. The person who writes out the order is the drawer, the person to whom it is addressed is the drawee, and the recipient of the money is the payee.

c. Example of International Trade Transaction. An illustration will serve to make clear the origin of bills of exchange. When, for example, an American exporting firm has sold a consignment of shoes to a British customer at a stipulated price of, say, £1,000, the British importer may authorize the American exporter to draw a bill on him, expressed in pounds sterling, payable at sight or within a stipulated period of time. The British importer's authorization is confirmed by his bank, acting through its New York agent. The American exporting firm may sell the bill at once to a banker in New York for collection and conversion into dollars. Let us assume it is a 90-day bill, *i.e.*, it is payable within 90 days after date by the British importer. The dollar value of this bill is computed by first subtracting 90 days' interest at the market rate prevailing in London from the face value of the bill (£1,000), and then translating it into dollars at the current exchange rate. Thus the American exporter, if he so chooses, receives dollar payment for the transaction at once, and consequently, as far as he is concerned, the transaction is completed unless, indeed, his foreign customer should fail to make payment. He has sold shoes abroad, and has been paid, even before the shipment has been delivered to his foreign customer.

The New York banker who has bought the bill may send it immediately to London to have it accepted by the drawee's bank on his behalf. The bill may be discounted in London, *i.e.*, sold to a discount house or bank, in which case the American banker would receive dollar funds abroad with the proceeds. Finally, within 90 days (or at maturity), the British importer pays his bill to his bank, which, in turn, pays off the discounted bill of exchange to the discount house. Thus, the exchange transaction growing out of the sale of American shoes abroad has been completed.

On the other hand, the New York banker may not discount the bill at once in London, but instead he may hold it as a short-term investment at the London rate. Whether he chooses to do so, rather than discounting it at once, depends on the current exchange rate and the comparative rates of interest in London and New York. If the sterling exchange rate is low relative to the dollar, he may hold the bill in anticipation of a rise in pounds, by virtue of which he would get more dollars in the conversion of his sterling claims. Moreover, if the London rate of interest is higher than the rate in New York, that fact also will tempt the owner to hold his bill until its maturity date.

d. Supply and Demand Factors. Where do the dollars come from, which the American banker may buy abroad with the proceeds derived from the bill of exchange? The British banker or dealer who sells dollars or dollar exchange in London has obtained them by purchase from British traders, who, in turn, have received them in payment for either commodities or services sold for dollars. The number of dollars available for sale on the part of the British banker will depend upon the volume of sales and possible advances made in terms of American dollars.

Thus, the supply of dollar exchange available abroad with which to make dollar payments, will, in turn, be limited by the extent to which American buyers either have paid in American monetary units for commodities and services bought abroad or have made dollar loans to foreigners.

11-6. Visible and Invisible Items of International Trade. Bills of exchange on any country do not originate merely from trading in commodities between residents in different countries. Transactions other than merchandise trades may create either a demand for or a supply of bills of exchange. All those transactions that demand international payments are known as items of international trade.

Items of international trade consist chiefly of commodity imports and exports, commonly referred to as visible items of international trade. In addition, there are a large number of invisible items, such as tourist expenditures, personal remittances, international loans, sale and purchase of securities held by foreigners, interest on foreign loans, shipping, banking, and insurance service charges, all of which require international payments,

and which, therefore, affect the supply of, and the demand for, bills of exchange on various foreign countries.

11-7. Effects of Various Items of Trade on International Exchange. *a. Demand for Foreign Bills.* Consider first the simple case of international trade between only two countries, such as the United States and Great Britain. Which of the foregoing items of international trade would create a demand for bills of exchange in New York on London, and which would create a supply of bills of exchange in New York on London? To reverse our former example, when American importers purchase commodities in England and make remittance, they create a demand for British currency in exchange for their supply of American dollars with which to pay for such purchases abroad.

Furthermore, when American tourists travel in England, they may have dollar letters of credit or dollar travelers' checks. With this supply of dollars they can demand British currency with which to pay for their hotel accommodations, transportation expenses, and other service charges. They are, as it were, consuming British goods and services in England rather than in the United States. This is obviously similar to an import transaction into the United States in that it creates a demand for British exchange.

Again, if British citizens come to the United States and sell their services here, converting the American dollars received by them in payment into bills of exchange on London to remit to their friends or relatives at home, such personal remittances are analogous to importing transactions and similarly create a demand for bills of exchange on London. Also, when Americans buy British securities that are paid for in British currency by selling dollars, a further demand for sterling exchange is created.

Again, if an American debtor has interest payments to make in Great Britain in pounds sterling, he may buy a bill of exchange on London with American dollars at the prevailing exchange rate, thus creating additional demand for British exchange in New York.

These illustrations serve to show how invisible, as well as visible, items of international trade create a demand for bills of exchange on a foreign country.

b. Supply of Foreign Bills of Exchange. Conversely, a supply of bills in New York on London will arise not merely from our commodity exports, but also from such invisible items of trade as borrowings in England, interest on investments abroad, and repayment of maturing obligations to us, as well as expenditures of British subjects visiting America and merchant-marine services rendered British residents by our merchant marine. For example, if an American firm made a loan in Great Britain that it wanted in terms of dollars, it could draw a bill on its British creditor for the amount of the loan and discount it at its bank. It would receive dollar

credit for the bill, even as did the exporter of shoes in the previous illustration on page 205. In like manner, other invisible items of international trade, as well as visible items, may create a supply of bills on a foreign country.

11-8. Bilateral, Triangular, and Multilateral Exchange. If merchants in only two countries, such as the United States and Great Britain, were engaged in international trade with each other, it is clear that, for every claim established against Great Britain by us, a counterclaim would have been established by Great Britain against us.[1] If we loaned British subjects a certain amount of monetary purchasing power by buying British industrial bonds, our foreign investments thus made would give us a claim against Great Britain. To the extent that this purchasing power was loaned to Great Britain, she could, in turn, claim our commodities and services. Thus, the loan might be offset by exports from the United States. Such a situation would be bilateral exchange.

But the claims of American traders on British bankers and of British traders on American bankers may also be offset against each other indirectly, as well as directly. For example, the value of exports from the United States to Great Britain is ordinarily far in excess of our imports from Great Britain. On the other hand, the value of our imports from Brazil exceeds the value of our exports to Brazil. If now Brazilian imports from Great Britain were greater than the value of her exports to Great Britain, then Great Britain would owe a net debt to the United States, the United States would owe a net debt to Brazil, and Brazil would owe a net debt to Great Britain. Bills drawn on London in payment of the British debt could thus be employed by American importers to pay their debts in Brazil, while Brazilian importers, in turn, could use these bills drawn on London to meet their obligations in Great Britain. Such an arrangement is known as triangular exchange; dealers in foreign exchange serve as middlemen in facilitating such transactions.

When many nations in international trade freely exchange the currency of one country into the currency of another country, many-sided or multilateral exchange takes place. Under such conditions the total estimated value of the visible and invisible items of international trade of a country will tend to be equal. They fail to balance exactly, on a composite statement of international payments, primarily because of possible errors in estimates of invisible items of trade.

11-9. International Receipts and Payments of the United States. The following statement in Table 6 of our account with the rest of the world in

[1] In the subsequent discussion such expressions as "trade between countries" and "claims against countries" are, in accordance with common practice, used interchangeably with trade among business units and claims against such units arising out of international commercial transactions.

TABLE 6. STATEMENT OF INTERNATIONAL PAYMENTS BETWEEN THE UNITED STATES AND FOREIGN COUNTRIES IN 1940 *

(In millions of dollars)

Classes of transactions	Exports Cash receipts from foreigners (credits)	Imports Cash payments to foreigners (debits)	Difference + net credits − net debits
Visible items other than gold and silver:			
Merchandise	$4,021	$2,625	+$1,396
Merchandise adjustment	68	44	+ 24
Invisible items:			
Freight and shipping	186	259	− 73
Travel expenditures	93	223	− 130
Interest and dividends	525	195	+ 330
Government transactions	32	123	− 91
Personal remittances	35	118	− 83
Institutional contributions	......	54	− 54
Miscellaneous services	89	63	+ 26
Total trade and service items	$5,049	$3,704	+$1,345
Capital items (net):			
Long-term capital movements	......	......	−$ 39
Short-term banking funds movements	......	......	+ 867
Special transactions of belligerent governments	......	......	+ 640
Paper-currency movement	......	......	+ 35
Miscellaneous items	......	......	− 1
Total capital items (net)	......	......	+$1,492
Gold and silver:			
Gold exports and imports	$ 5	$4,749	−$4,744
Gold earmarking operations (net)	......	......	+ 645
Silver exports and imports (net)	......	......	− 55
Total gold and silver movements (net)	......	......	−$4,154
Balances residual item (net)	......	......	+$1,317

* Adapted from "The Balance of International Payments of the United States in 1940," p. 4, U. S. Department of Commerce, 1941.

1940—our last full prewar year—presents the chief groups of both visible and invisible items of international trade. For strategic reasons, publication of the annual bulletin on international payments was discontinued by the government after 1940, and for the duration of the Second World War.

11–10. Settlement of Balances under Former International Gold Standard. *a. Gold Shipments Related to Pars of Exchange.* International payments for both visible and invisible items of trade are made primarily by means of bills of exchange. Even under the traditional international gold standard, gold was shipped from one country to another in payment of balances only if the market rate of exchange varied above or below the gold par of exchange (the ratio between the gold content of the monetary unit of one country and that of another country) in excess of the actual costs of shipping gold. In other words, when a nation had an adverse trade balance, *i.e.*, when the value of imports (visible and invisible) exceeded the value of exports (visible and invisible) causing bills on foreign countries to rise above the gold shipping point, gold was sent out to settle such an adverse trade balance. Conversely, a nation whose total exports over a period of time exceeded its total imports, in value, imported gold in settlement of the trade balance in its favor. For example, with reference to France and the United States prior to 1933, if total international payments due in Paris exceeded total payments due in New York, the difference between these two items would normally be settled by actual gold shipments from New York to Paris as soon as the rate of exchange had passed above the gold shipping point that allowed for costs of transporting and insuring gold.

b. Effects of Gold Movements on Prices. According to classical theory of international trade and price movements in freely competitive markets among gold-standard countries, whenever the rate of exchange was such that gold flowed out in settlement of foreign balances, certain corrective influences would begin to operate.

As gold left a country, its supply of standard money would be diminished. Since such standard money was held primarily in banks as reserves against outstanding notes and deposits, diminishing bank reserves would tend to reduce the available quantity of money and bank credit. Bank loans might be called and interest rates raised to check further credit expansion because of declining reserves. On the other hand, the country receiving a large importation of gold would find its gold reserves increasing. This in turn would increase the available supply of money for bank credit expansion. In order to stimulate borrowing of the augmented funds, banks would lower their rates, and increased borrowing of cheaper loan funds would tend to raise prices.

Through the contraction of currency in the country that was losing gold and the expansion of currency in the country receiving the gold, it was as-

sumed, in accordance with quantity theory of money, that prices would move downward in the former and upward in the latter. Thus the free movement of gold from one country to other gold-standard countries in order to settle balances would set forces in motion that would counteract its continued flow in one direction. As the country that had been exporting gold and was experiencing a downward pressure on prices expanded its exports and decreased its imports, because of the opposite price trend in the gold-importing country or countries, it would gradually increase the claims it held against foreign countries. This would tend to raise the rates of exchange on such foreign country or countries once more to the gold par of exchange, when claims and counterclaims would be settled with bills of exchange and equilibrium between exports and imports would have been restored.

All this assumed that gold movements from one country to another would be permitted to affect prices accordingly. When, however, banking policy of a country was consciously directed toward internal price stabilization, an outflow of gold would not be permitted to induce a downward pressure on prices. Central banks could on the one hand expand bank credit to offset the loss of gold, and on the other hand, "sterilize" gold imports to prevent their serving as a basis for credit expansion, through their control over discount rates and by open-market operations. Even before the First World War the international gold standard was at best a semiautomatically functioning standard, because of a certain degree of control exercised by central banks and governments over the international movement of gold, often motivated more by narrow nationalistic objectives than by broader international interests.

11–11. Mechanism of International Payment after the First World War. *a. Abandonment of International Gold Standard.* The mechanism of financing international trade underwent decided changes after the First World War. The semiautomatic gold standard that most trading countries had adopted during the nineteenth century had functioned fairly well prior to 1914 in settling trade balances. Indeed it had achieved a high degree of stability in exchange rates among the currencies of various countries.

Attempts to restore the international gold standard after the First World War met with only temporary success. Not only the postwar instability of world markets but also currency devaluation and price inflation in many countries precluded the successful resumption of the traditional international gold standard. Manipulation of foreign bank balances and control over international long-term capital movements also interfered with its effective operation. Moreover, other obstacles were placed in the way of the international flow of commodities, through increasing protective tariffs, quota arrangements, exchange controls, bilateral clearing agreements, and various other trade restrictions.

While, as previously noted, even before the First World War there had been a certain amount of governmental and central-bank interference with the operation of the gold standard, the degree of currency management and control by central banks increased, particularly during the depression of the thirties, when most countries again abandoned the gold standard, which they had laboriously sought to restore during the twenties. Beginning in 1931 with the abandonment of the gold standard by Great Britain, other countries soon followed suit, until the traditional gold standard had, as one commentator expressed it, been "relegated to the scrapheap of outmoded institutions" by practically all important trading countries.

b. Imposition of Exchange Controls. In its stead, governments of various countries sought to promote their national commercial interests by such devices as unilateral exchange controls and bilateral trading agreements, at times reverting to primitive methods of barter. This was particularly true of Nazi Germany. But even before the Nazi government was established in Germany, the use of exchange controls as a governmental device to regulate international economic relations had been adopted by central European countries. While employed as emergency measures in the first instance to prevent "flight of capital," exchange controls gradually came to be used by governments as weapons of commercial policy. The arbitrary allocation of foreign exchange to traders who might be in governmental favor or who were manufacturing armaments and the cheapening of exports by subsidizing exporters in order to acquire the desired foreign exchange to carry out governmental policy or plan—all contributed to drying up the normal channels of multilateral international trade.

In addition to exchange controls, which were unilateral actions, countries also adopted bilateral clearing agreements, which made for economy in the use of foreign exchange. Such clearing arrangements differed from traditional multilateral clearing or settling of accounts in international trade in that they were usually made between only two countries which agreed to offset exports and imports. At times a specific item of export was exchanged for an equivalent value of a specific item of import, in which case the transaction reverted to a simple barter arrangement. Such transactions, referred to as compensatory agreements, include intergovernment as well as purely private transactions.

Whereas many clearing and compensatory agreements adopted by commercial countries during the thirties did not require the use of foreign exchange in making international payments, the so-called "payments" agreements, entered into primarily by debtor with creditor countries, involved the use of foreign exchange. Thus a debtor country might, under a payments agreement, use a part of the currency of the creditor country, derived from exports to that country, for debt service charges, use another part to pay for imports from the creditor country, and sell any balance of

foreign exchange at the official rate to any buyer in the exchange control country.

11–12. Postwar Bilateral Trade Agreements. Bilateral trade agreements and exchange controls were continued in the period after the Second World War. For example, trade agreements, almost bilateral in nature, were entered into between Great Britain and Argentina in 1945, as well as between Great Britain and the Scandinavian countries. Moreover, the Soviet Union entered into a series of bilateral trade arrangements with eastern European states. The trend in the immediate postwar period in Europe was distinctly in the direction of bilateral or barter agreements and away from multilateral exchange in free markets.

This trend developed out of the distortion of the international exchange relations, disruption of transportation systems, and varying degrees of currency depreciation in different countries growing out of the war, as well as the urgency of the need for immediate postwar relief "on any terms." Moreover, it was also induced by political considerations, such as the desire of large powers to extend and strengthen their spheres of political influence.

The full economic and political implications of exchange controls and bilateralism must be understood if we would seek to develop better commercial relations among the nations of the world than existed during the depression years of the thirties. Since the Second World War did not remove these conditions but actually made them worse, particularly in devastated European countries, it is not difficult to understand why bilateral barter exchange was revived in the immediate postwar period. The Marshall Plan for the economic recovery of European countries was designed to counteract this trend and to restore the basis for multilateral exchange among trading nations.

11–13. Implications of Exchange Controls and Bilateral Agreements. Exchange controls as emergency measures designed to prevent flight of capital, to protect the currency, and to conserve exchange for foreign debt payment may represent helpful protective measures in an actual emergency. But they become powerful tools of political and economic control in the hands of any government. The fact that they originated as emergency measures in the thirties does not minimize their significance as possible permanent devices for controlling international relations, as attested by their revival after the Second World War. A country enjoying monopolistic advantages either as buyer or seller may so modify the terms of trade through unilateral exchange control as to increase its "total gain" from international trade. By manipulating the exchange rate, the controlling agency can give direction to imports and exports, direction based not on the traditional concept of comparative costs but on political expediency.

The relative ease with which unilateral governmental exchange controls can be converted into international trade controls is quite obvious. By being able to ration the available foreign exchange, such a government is in a position to give direction to both the composition and the flow of international trade. To be sure, if purely economic considerations motivated the actions of the controlling agencies, multilateral international trade might develop even under exchange control. But in the light of experience, we cannot realistically ignore the political implications of governmental control over foreign exchange.

The question of the future is not so much one of whether governmental exchange controls and clearing agreements will continue in the postwar era, but more fundamentally, how they will be employed. If used as instruments of purely nationalistic policy to force foreign trade into bilateral channels and to control the composition of such trade by governments, the logical consequence will be further shrinkage of international trade.

The percentage share in total gold value of exports of European exchange control countries declined from 27.2 per cent in 1931 to 22.5 per cent in 1937. This decline may be attributed, in large part, to unilateral exchange controls and bilateral clearing agreements. It would have been considerably greater if it had not been expressed in terms of overvalued currencies of exchange control countries.

The question may be raised whether the decline in international trade during the thirties between exchange control countries was due to internal overvaluation of the currency or to bilateralism. In general, bilateralism would tend to level trade downward since it limits choice both of buyers and of sellers to the products of two countries. On the other hand, internal overvaluation of currencies in exchange control countries, in the face of their actual external devaluation, creates risks owing to uncertainty as to "controlled" exchange rates; and so it contributes to shrinkage of foreign trade. Thus both factors tend to diminish the volume of international trade and to alter its natural composition.

In view of the restricting effects of exchange controls and bilateral clearing agreements on international trade, as well as their political implications, various monetary experts in leading commercial countries, even before the close of the Second World War, submitted plans designed to facilitate and promote postwar multilateral trade. These plans served as the basis for the agreement to establish an International Monetary Fund and an International Bank for Reconstruction and Development, arrived at by delegates of 44 nations assembled at Bretton Woods, New Hampshire, in June and July, 1944.

11-14. International Monetary Fund. The avowed purpose of the International Monetary Fund is to provide as much stability in foreign exchange rates as feasible, without sacrificing, by rigid adherence to the

traditional gold standard, either national or international freedom of action in coping with problems of domestic economy. While gold continues as a means for settling trade balances, it does not function as the traditional gold standard did. Exchange rates are not necessarily altered as a result of the movement of gold from one country to another.

The Fund is in the nature of an internationally managed currency, although no specific monetary unit is named in the plan. As soon as possible after the Second World War, the par value of each member country's currency was to be fixed in terms of either gold or United States dollars of the weight and fineness in effect July 1, 1944.

These par values were intended to bring the internal value of each member country's currency into equilibrium with the existing gold convertible currency, *i.e.*, the United States dollar, which was convertible into gold for export, though not for domestic purposes. The par value of a national currency may be changed unilaterally by any member country after consultation with the Fund, but not by more than 10 per cent, cumulative, of the initial par value, either upward or downward. Any further change in the par value of one country's currency must be approved by the executive committee of the Fund; it must be warranted because of fundamental conditions of disequilibrium in the current trade balance. But the gold value of the currencies of all members may be changed uniformly at the same time, whenever it is deemed desirable and approved as specified in the plan. Exchange rates would not be affected by such action, but monetary reserves would be changed in all countries in proportion to their gold holdings and to the extent of the change. Such a change might also stimulate gold production if the price of gold were to be raised uniformly in all countries. But how it would affect production, and prices in general, in various countries cannot accurately be foretold.

The Monetary Fund was intended to be used to offset temporary fluctuations in exchange rates and to correct fundamental or continuing factors making for disequilibrium in international trade. It represented in essence a compromise between the rigidity of the traditional gold standard and the uncertainties of independent inconvertible paper currencies.

Each country participating in the Fund was assigned a subscription quota, which it must pay to the Fund in accordance with schedules specified in the plan. The aggregate initial quotas allotted to the 44 member countries subscribing to the Fund amounted to 8.795 billion dollars. The three largest quotas were those of the United States, Great Britain, and the Soviet Union, together comprising nearly 60 per cent of the total initial subscription quota. The United States quota alone was 2.75 billion dollars.

The quota of each country was to be paid in gold, up to either 25 per cent of its quota or 10 per cent of its holdings of monetary gold and United States dollars, whichever sum was smaller. Each country was limited in

the sale of its currency for the currencies of other countries, *i.e.*, in its borrowing from the Fund, to 25 per cent of its quota in any 12-month period. This borrowing from the Fund by the sale of its currency might be continued until a country's borrowings from the Fund were equal to double its quota. But even before this limit of borrowing had been reached, the Fund could conceivably take measures designed to correct the need for further short-term credit. Moreover, the Fund was not intended to provide facilities for relief or reconstruction nor to aid in the flight of capital from a country.

The primary purpose of the Fund was to provide means of making international payments and to give its members, within limits set in the agreement, wherewithal to meet temporary deficits in their international balance of payments. The effective operation of the Fund would thus decrease the need of adopting various trade restrictions, as was done particularly during the thirties, to achieve balance between exports and imports.

Of the 44 governments that had participated in drawing up the Bretton Woods agreements, 33 ratified the agreements before the close of 1945. This represented approximately 80 per cent of the total quotas, and was sufficient to assure the establishment of the Fund as a new agency designed to promote international monetary and financial cooperation. For reasons not made known, the Soviet Union had not seen fit to become a member of the International Monetary Fund by 1948 although her delegates had participated actively in drawing up the plan in 1944.

11–15. International Bank for Reconstruction and Development. In addition to the International Monetary Fund for current transactions, the Bretton Woods conference also adopted a plan for the establishment of the International Bank for Reconstruction and Development, to promote the use of long-term investment credit for reconstruction and development and to encourage the export of capital for productive purposes from those countries that are in a position to make long-term loans (notably the United States) to countries in need of such loans. The plan provided for authorized stock of the Bank, amounting to 10 billion dollars, divided into shares having a par value of $100,000 each. Subscriptions to shares may be made by member countries only in accordance with the schedules provided in the plan. Of the total subscription to the stock of the Bank, 20 per cent was to constitute the Bank's own loan fund, while 80 per cent was to be a guarantee fund to cover possible losses on its own obligations or those guaranteed by the Bank. In general, 2 per cent of the initial subscription of each member was payable either in gold or in United States dollars. The International Bank may lend funds directly, participate in loans, or guarantee loans floated through private investment channels. Respecting loans to be made by the Bank, emphasis was to be placed in

the loan agreement on their productive nature and economic soundness, rather than on political considerations.

Both the proposed Fund and the Bank were international cooperative ventures designed to help solve the problems of prewar disorderly and unstable exchange rates and unsound foreign investments, as well as of wartime distortion and disruption of normal commercial relations among the nations of the world. Since the Fund represented a greater departure from traditional methods of financing international trade than did the proposed International Bank, it was therefore subjected to greater scrutiny and criticism.

11–16. Criticism of the International Monetary Fund. The Fund has been adversely criticized as a novel and untried proposal designed to encourage member countries to borrow from the Fund to pay for imports, without offering them sufficient inducement "to put their own houses in order" so as to effect an orderly balance of their international payments. It has also been objected to on the grounds that it gives member countries the right to borrow from the Fund, while leaving little discretion to the Fund to refuse a loan. Moreover, it has been contended that the United States will be the only country contributing to the Fund currency that has real value, because of our large gold holdings. Other countries, it is argued, will sell their relatively worthless currencies to the Fund for American dollars at predetermined stable exchange rates, until the supply of dollars and gold in the Fund is exhausted and the United States is left "holding the bag" of relatively worthless currencies. We could, of course, protect ourselves against such an eventuality by using these currencies to pay for increased purchases abroad.

This suggests the importance of expanding our imports in order to create a counterdemand for foreign currencies on the part of the United States. As one of the delegates to the Bretton Woods Conference expressed it, "It is to be hoped that before the dollars in the Fund have become scarce, the American people will have come to a greater maturity in their economic thinking and will radically change their present tariff policy." It is impossible to maintain even moderately stable exchange rates in free exchange markets without maintaining an orderly flow of goods, both of exports and imports, across national boundaries. International trade must come to be recognized as two-way and not one-way traffic if we would seek to achieve postwar exchange stability through an equilibrium between exports and imports of commodities and services.

11–17. Questions of Exchange Rates and Currency Values. Some concern has also been expressed over the possibilities of unilateral action in changing initial exchange rates, cumulatively, up to 10 per cent. Under the traditional gold standard, rates of exchange fluctuated less than 1 per cent above and below the gold par of exchange as determined by the costs

of shipping gold. It should be remembered, however, that a larger degree of flexibility in exchange rates than that which existed under the gold standard will be necessary for some time after the Second World War because of the distortion of world markets and the development of new and substitute products growing out of the war. Moreover, the initial exchange rates adopted by individual countries at the time of ratifying the Bretton Woods agreement may deviate considerably from the prevailing official rates. Thus, before France signed the agreement, the French government devalued the French franc from 50 to 119+ francs per dollar or 480 francs per pound sterling. This new rate of exchange was intended to bring the external buying power of the franc in line with its internal buying power. Before devaluation it had been apparent that the French franc had been decidedly overvalued externally.

Moreover, prior to the establishment of the Fund as a going concern late in 1946, both Canada and Sweden revalued their currencies upward, relative to the United States dollar. The Canadian dollar was restored to parity with the United States dollar in July, 1946, by an official upward revision of about 10 per cent while the Swedish krona was raised 14 per cent in value, relative to the American dollar. These unilateral measures were seemingly invited by the rapid rise in prices in the United States with the expiration of price controls on July 1, 1946. Raising the values of foreign currencies in terms of American dollars under these conditions would tend to encourage imports by these countries of scarce goods from the United States. In the face of world-wide demand for their products, the higher price of their currency would impose no undue hardship on exporters.

Once the Fund has been organized and satisfactory exchange rates have been established by international cooperation, after what may be called a period of trial and error, the need for unilateral action will be minimized. A major problem that confronted the Fund at the outset was that of selecting appropriate initial rates of exchange.

> But certain features of a free market can and should be introduced right from the beginning; the exchange rate of a currency should be uniform, non-discriminatory. That is to say the same rate should be applicable to all types of transactions and to all individuals, to commodity trade as well as to services, capital and interest payments. [Even with continued exchange controls exercised for some time in the postwar period by various countries the above objective of a free exchange market imposes severe restrictions on any attempt at doctoring the terms of trade.[1]]

While both the Fund and the Bank were geared to governmental controls—functioning through governmental agencies and central banks—their

[1] Haberler, Gottfried, The Choice of Exchange Rates after the War, *American Economic Review*, vol. 35, No. 3, June, 1945, p. 308.

avowed purpose was to make possible a return to foreign exchange markets with a substantial degree of freedom of action on the part of private commercial interests engaging in international trade. Much of the prewar foreign exchange mechanism prevailed under the Fund, although intergovernmental supervision and control were designed to prevent the violent fluctuations in exchange rates, which frequently grew out of unilateral exchange manipulation in the prewar period.

11–18. Balanced Trade a Requisite to Success of Fund. In the final analysis, all attempts at exchange stabilization will be frustrated unless the many artificial restrictions on the international flow of commodities and services are promptly reduced and ultimately removed. Only as nations can be induced to enter into normal trade relationships with each other, on the principles of comparative advantage and of reciprocity, will the requisites for stabilized exchange rates by international agreements be provided. The postwar revival of world trade is largely dependent on sound international mechanism of exchange. But the continuation of such trade rests upon an intelligent application of the basic principles underlying international trade. If these principles do not form the basis, the disrupting influences of unbalanced trade, such as excessive international indebtedness, artificial trade restrictions, and intensified nationalistic rivalries, will eventually tend to make unworkable any international monetary mechanism, irrespective of its metallic base.

Such trade implies a willingness to buy as well as to sell on the part of all countries. Artificial trade restrictions, exchange controls, import quotas, and subsidies can, and do, influence the direction of international trade. But, in the last analysis, every nation will seek its own benefits in international trade. These grow out of territorial division of labor and the operation of the principle of comparative advantage. To the extent that these factors are not permitted to operate because of artificial trade barriers, they limit the mutual benefits of international trade. The net result is an economic loss, although the political gains derived from foreign trade restrictions may be regarded as sufficient to warrant the cost.

If international trade is to rest on a firm foundation, it will be necessary to dispel the popular illusion that trade consists merely of selling. It must be reiterated in conclusion that it is impossible to sell without buying, and that the gain from trade grows out of what one buys as much as out of what one sells. An understanding and application of these underlying principles of reciprocity and mutual gain in all trade is a prerequisite for the establishment of international trade and foreign exchange on a sound economic basis.

Guide Questions on Text

1. What is meant by international trade?
2. Point out the similarities between domestic and international trade.

3. In what important respects does domestic trade differ from international trade?

4. What are the reasons for international trade? Do these reasons differ from those for domestic trade? Why or why not?

5. Show how differences in production costs in two countries form the basis for mutually beneficial trade.

6. Explain clearly how international payments are made.

7. Trace, step by step, how an American exporter of automobiles to France may proceed to receive payment for these automobiles, even before they arrive in France.

8. Distinguish between visible and invisible items of international trade, and give illustrations of each.

9. Distinguish between bilateral, triangular, and multilateral exchange.

10. What are the limits of exchange rate fluctuations between two gold-standard countries? Why?

11. Show how gold movements between gold-standard countries may make for restoring equilibrium between exports and imports.

12. How may central banks interfere with the functioning of the international gold standard? What evidence is there that they have done so in the past?

13. Account for the breakdown of the international gold standard after the First World War.

14. Why did efforts to restore an international gold standard during the thirties fail?

15. What were the consequences of this failure?

16. Analyze the economic implications of the development of exchange controls.

17. "The purpose of the International Monetary Fund is to provide as much stability in foreign exchange rates as feasible, without unduly sacrificing either national or international freedom of action in coping with problems of domestic economy."

a. Distinguish between the International Monetary Fund and the traditional gold standard.

b. Explain the differences between the operation of the Fund and the traditional gold standard.

18. Evaluate the several criticisms that have been made of the International Monetary Fund.

19. Distinguish between the functions of the International Monetary Fund and the International Bank for Reconstruction and Development.

20. Both "the Fund" and "the Bank" are international cooperative ventures. Explain.

21. What are the basic requisites for achieving and maintaining international monetary stability?

Topics for Investigation

1. Similarities and differences between the international gold standard and the International Monetary Fund.

2. Distortion of our international commercial relations growing out of the Second World War.

3. Relative importance of invisible items in the balance of payments of various commercial countries.

4. Types of bilateral agreements entered into by various countries since the close of the Second World War.

5. Methods of arriving at initial exchange rates by member countries of the International Monetary Fund.

6. Criteria of "productive" international loans made through the International Bank for Reconstruction and Development.

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CHAPTER XII

INTERNATIONAL TRADE AND FOREIGN INVESTMENTS

12–1. Relationship between International Trade and Foreign Investments. There is an intimate relationship between international trade and foreign investments. It is not so much the volume of a nation's foreign trade nor the value of the exchanged commodities that affects the international ebb and flow of capital funds. It is rather the "balance of payments," the difference between the value of imports and of exports, both visible and invisible, which reflects either the debtor or the creditor status of a nation. When invisible items of international trade, such as personal remittances, tourist expenditures, and merchant-marine and banking-service charges are relatively unimportant, and when, under such conditions, an unfavorable trade balance is not settled by specie payment, the nation with the adverse merchandise trade balance is either increasing its foreign debts or is receiving payments on previously made foreign investments. In other words, it stamps a country either as a debtor or a creditor nation.

12–2. Favorable and Unfavorable Balance of Trade. The terms "favorable" and "unfavorable" balance of trade are used in the following discussion in the popular, rather than the literal, sense. They are survivals of eighteenth-century mercantilistic doctrines, expressing the belief that a nation gains when the value of its visible exports exceeds that of its visible imports over a period of time, thus necessitating an influx of specie to settle such a "favorable" trade balance. On the other hand, a nation is regarded as losing when the value of its visible imports exceeds that of its visible exports, necessitating a net outflow of specie in settlement of its "adverse" trade balance. As will be seen in the subsequent discussion, a country may have either a favorable or an unfavorable balance of trade, depending on its status as either a debtor or a creditor nation. Neither situation is necessarily or inherently good or bad.

12–3. Development of Foreign Investments. During the early stages in the development of a nation the borrowing country will have an unfavorable balance of trade; it is receiving some commodities from abroad for which it is not making immediate and full payment by exporting goods. To the extent that payments for the excess of commodity imports over exports are deferred, a nation becomes indebted to other nations. On the

other hand, a creditor nation can export a greater value of goods than it imports; its foreign investments will normally increase thereby. This is the case particularly when invisible items of international trade other than investments play a relatively unimportant role, and when specie payments are not made to settle adverse balances.

When, after a period of time, the borrowing country begins to repay principal and to pay interest, in excess of the amounts of new loans it is making abroad, its balance of payments will normally be reversed. It will show an excess in the value of commodity exports over the value of imports. On the other hand, the creditor country or countries will have an unfavorable trade balance, the value of their imports being greater than the value of their exports. This is so because the debtor country is required to make payments for that which it has previously bought abroad, if it is going to honor its obligations. On the other hand, the creditor countries, to the extent that they want payment of foreign obligations, must accept commodities and services from abroad.

12-4. Four Types of Nation. A distinction may be drawn among four groups of countries, with reference to their international trade balances and their flow of capital investments. There are (1) immature debtor countries, (2) mature debtor countries, (3) immature creditor countries, and (4) mature creditor countries.

a. Immature Debtor Countries. These will normally show an excess in the value of imports over exports while capital investments are flowing in from abroad. Foreign investors of capital funds will lend the necessary monetary purchasing power required to pay for the goods not paid for with exports. From 1849 to 1873, the United States was such an immature debtor country.

b. Mature Debtor Countries. These countries may continue to borrow abroad, but the volume of new loans does not equal the annual interest and amortization payments on formerly contracted international obligations. Such countries will have a favorable trade balance, the excess in the value of exports measuring approximately the excess of interest and amortization payments over new debts incurred abroad and payments on foreign obligations due them. From 1873 to 1915, the United States was such a mature debtor country.

c. Immature Creditor Countries. These countries will normally show an excess in the value of exports over imports, which excess will measure approximately their increase in foreign investments from year to year. Particularly during the twenties, the United States displayed the characteristics of an immature creditor country, its favorable trade balance roughly measuring the increase in its capital investments abroad.

d. Mature Creditor Countries. These are countries which have invested heavily abroad and which are receiving interest and debt repayments in

amounts larger than those representing possible additional foreign investments. Under these conditions they will normally show an unfavorable trade balance, the excess in the value of imports over exports reflecting the excess of interest and debt repayments over new investments abroad and payments on their own foreign debts.

In times of a national emergency such mature creditor countries may liquidate their foreign investments to purchase sorely needed supplies in foreign markets. For example, Great Britain used many of its foreign investments, made during its period of international economic expansion, to aid in war financing; during the First World War and again during the Second World War it liquidated large parts of its foreign holdings to pay for war supplies in foreign countries.

In general, the mature creditor status of commercial nations has developed at an accelerated pace, primarily in times of war. The resultant rapid repayment of foreign loans has created serious postwar problems for countries that thus "lost" their foreign investments as a source of continued peacetime income. A major argument advanced in favor of the 3.75-billion-dollar loan made by the United States to Great Britain in 1946 centered around the loss of returns on British foreign investments as a result of wartime liquidation of her foreign holdings.

12-5. Development of Our International Trade. Prior to 1850 discrepancies between the values of commodity imports and commodity exports of the United States were settled largely by shipments of specie. Securities or foreign loans played only a negligible part in trade balances.

The period from 1849 to 1873, on the other hand, was characterized by an unusually large excess in the value of imports over exports. This was due to the increased gold production since 1849, the hampering effects of the Civil War on our export trade, the decline of the American merchant marine, and the great increase in the amounts of foreign capital funds borrowed for domestic investment. Reconstruction activities after the Civil War and railroad building in the Middle and Far West created extensive demands for capital funds. It has been estimated that 1 billion dollars were invested by foreigners in the United States from 1850 to 1873.

During the 20 years from 1873 to 1893 the excess in the value of merchandise exports over imports of this country had an average annual value of 113 million dollars, representing, to a large extent, interest payments on foreign debts. From 1893 to 1914, the balance of international payments continued to be favorable to the United States, and on an even greater scale. The average annual value of commodity exports exceeded that of imports by about 485 million dollars. This large favorable trade balance was offset in part by tourist expenditures, immigrant remittances, and purchase by Americans of European securities but chiefly by payments due on outstanding foreign obligations. By 1910 between 5 and 6 billion dollars'

worth of foreign capital had been invested in the United States. Interest and sinking-fund charges on this large investment exceeded 300 million dollars annually and, even after making allowance for approximately 75 million dollars interest on United States investments abroad, a net interest claim of between 200 million and 225 million dollars had to be met by the United States annually for several decades prior to the First World War.

12-6. Change of Status Owing to World Wars. But our international financial status was changed from a mature debtor to an immature creditor

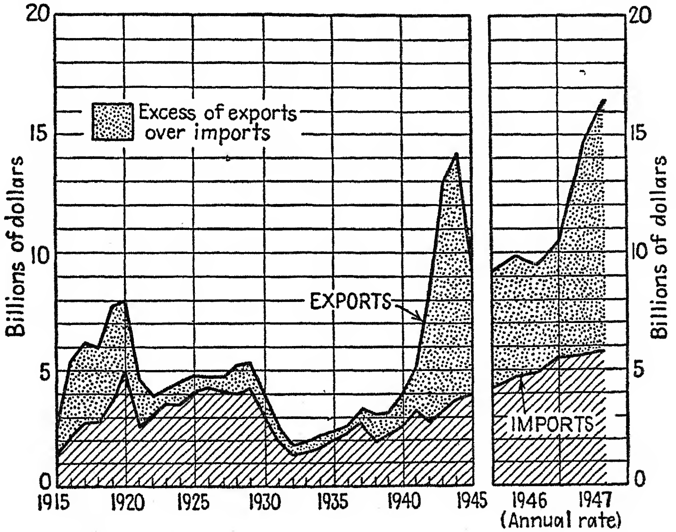

CHART 6. Effect of world wars on American exports. (*Data from President's Midyear Report to Congress, 1947. Chart from The New York Times, Sunday, July 27, 1947.*)

country as a result of the First World War. From the summer of 1914 to December, 1918, the excess of American commodity exports over imports totaled 11.8 billion dollars, while the export balance for the fiscal year ending June 30, 1919, alone exceeded 4 billion dollars. After 1919 our annual favorable trade balance, although somewhat smaller, continued from year to year. For the calendar year 1940 the merchandise trade balance of the United States showed an excess of exports over imports valued at about 1.4 billion dollars. This is shown in Chart 6.

The large interwar favorable merchandise trade balances of the United States were offset, in part, by invisible items of import, such as tourist expenditures and personal remittances, as well as by repurchases of American securities held abroad and net imports of gold. But a further offsetting item was our long-term foreign investments in the interwar period. In 1944, our gross private long-term investments abroad were estimated

at approximately 10.6 billion dollars, of which upward of 70 per cent represented direct investments in various industries, such as public utilities, manufacturing, mining, and agriculture. These foreign investments did not include the foreign government debts owed to the United States arising out of the First World War, which in 1942 had a nominal value of almost 14 billion dollars.

The change in our status from a mature debtor country to an immature creditor country has come about in such a relatively short period of time that many persons have failed to grasp the full economic significance of this change.

12-7. Significance of Our Changed Status. When a person owes someone else a certain sum and expects to meet his obligation, his primary concern is to provide the necessary funds with which to pay his debts. He will ordinarily obtain the requisite means to make payments by selling his services or the products of his labors to others for money or its equivalent. The money income that he has thus obtained is made available for debt payment. But before he can utilize any of his earned income to pay his debts, he must provide for his necessities, such as food, shelter, and clothing. Not until he has acquired a surplus over and above that which is necessary to maintain his industrial efficiency can he normally hope to make debt payments. In the absence of income from other sources, a person must work and save a portion of his income to pay his debts. His ability to realize an income, in modern industrial society based on division of labor and exchange, will ultimately be limited by his ability to sell his products or services. Unless he can find someone who will pay him for his labor or for the products of his labor, he cannot provide means with which to meet his obligations. This is true no matter whether he is indebted to a fellow citizen or to a foreigner.

Before the First World War, the United States was a mature debtor nation. We owed more abroad than foreign countries owed us. Our problem was, therefore, to provide the wherewithal to meet these foreign obligations. Proceeds derived from the sale of goods abroad, which were immediately employed to buy other goods in foreign lands, could not be applied toward debt payment. Only the excess value of exports over imports, resulting in a surplus of funds, was available for the payment of foreign obligations. To create such an excess, the people of the United States had to sell more goods abroad than they bought, just as earlier in their history they had bought more goods abroad than they had sold.

The foreign trade policy of our Federal government was devoted to stimulating our necessary export trade. Consular service was established in the leading ports of the world. Commercial attachés in foreign cities collected much valuable information concerning market conditions abroad. Special agents of the Department of Commerce from time to time in-

vestigated trade conditions in foreign lands with a view to widening the markets for our products. Trade reports, prepared and published periodically, were circulated in order to keep American exporters informed as to business opportunities abroad. Building up our foreign trade was commonly construed to mean facilitating our exports. Little or no attention was paid to the development of our imports. They were regarded by many as a necessary evil, incidental to our export trade. Our traditional tariff policy reflects our aversion to large imports.

Prior to the First World War our favorable trade balance from year to year had come to be looked upon by many as the natural order of things, as indeed it was under then existing conditions. In the minds of most people it was indicative of national progress and prosperity; only a few fully comprehended the real reason for our continued favorable trade balance. Despite our changed status from a mature debtor to a creditor nation, many continue to view with apprehension the possibility of an adverse balance of trade. They fail to realize the vital relationship between foreign trade balances and the international ebb and flow of capital investments, outlined in the preceding pages. Today, as before the First World War, they still advocate wider markets for our surplus products, a building up of export trades and increasing foreign investments; but, indicative of their aversion to imports, they continue to favor not only high rates of protection for American industries but also an American subsidized merchant marine to carry "American goods in American bottoms."

12–8. Our Declining Creditor Status during the Thirties. The net long-term private indebtedness owed abroad to American investors declined considerably during the thirties. Although the gross long-term foreign debt owed to us in 1944 totaled 10.6 billion dollars, foreigners had an offsetting long-term investment in the United States estimated at 6.2 billion dollars.[1] This reduced our net long-term international creditor status to 4.4 billion dollars, which was less than one-half of what it had been in 1930, and only about one-fourth of the former maximum foreign credit position of Great Britain. As a matter of fact, when short-term credits and debits are considered and lend-lease credits are omitted, the United States in 1944 actually owed 1.2 billion dollars more abroad than was owed by foreign countries in the United States. But this situation soon changed very rapidly with the withdrawal of short-term funds by foreign creditors after the close of the war, as well as with the expanded use of such credits to make purchases in the United States.

Although our long-term international creditor position declined considerably during the thirties as a result of debt redemption, as well as the decline in the dollar value of debts, there is every likelihood that it will again expand in the future.

[1] *Foreign Commerce Weekly*, Jan. 27, 1945, pp. 5*f*.

12–9. Extension of Our Immature Creditor Status after the Second World War. For some years after the Second World War the United States was frequently called on to make liberal long-term loans to war-torn foreign nations. The depleted resources of these countries, their ruined industries, and disrupted transportation systems precluded their achieving an early balance of international payments with sufficient exports to pay for imports. They were forced to buy on credit or accept gifts, or both, to aid them in reconstructing their impoverished economies.

Loans from the United States can help to restore world trade. But these loans must be considered carefully both as to amount and purpose. They must be made with a view to promoting the productive expansion of the borrowing countries so that they may, in turn, eventually be able to make repayment with exportable surpluses produced at low unit costs. It is not enough to consider solely the possible favorable effects of loans on the economies of the borrowing countries. Unless such loans also improve the position of these countries in their international commercial relations, there is little likelihood of debt repayment.

It would, moreover, be economically unsound for the United States to extend liberal international credits in the postwar era merely to maintain high levels of domestic employment. A continued policy of exporting our unemployment does not mean permanently increased domestic prosperity. It is illogical to assume that only by exporting our surplus goods, made available by our inordinately productive economy and the current emergency demands on it, will we be able to solve the perennial problem of relative scarcity of goods to satisfy man's limitless wants.

The economic benefits to the United States of our foreign investments must ultimately be realized by expanding our imports. Unless we are eventually willing to accept an excess of imports over exports, efforts to stabilize exchange rates by the International Monetary Fund will prove futile. International monetary stability cannot be maintained in free exchange markets if a chronic shortage of dollars were to arise out of a continued excess of exports from the United States over imports. Nor would the situation be corrected by continuously converting short-term debts into long-term obligations. This would merely be postponing the day of reckoning, when we would have to change our traditional foreign trade policy and encourage more imports.

While the expansion of export markets holds the center of popular attention at the present time [1946], the question of repayment by imports cannot be long deferred. To provide employment in the period of reconversion every effort will be made to stimulate exports, but in the long run and not too long a run, some answer must be given to the question of payment.[1]

[1] Gulick, R. L., Jr., "Imports—The Gain from Trade," Introduction by J. B. Condliffe, p. 9, Committee on International Economic Policy, N. Y., 1946.

In the face of our long-term international creditor status and the need for further expansion of our foreign investments to aid in the economic reconstruction of war-torn areas, we must face realistically the problem of repayment. How can we expect foreigners to meet their financial obligations to us, in whole or even in part, if we continue to restrict their efforts to obtain dollar exchange by selling us some of their goods?

If we would change our status from that of an immature creditor country to that of a mature creditor nation, we must, therefore, become reconciled to an import rather than an export trade balance. This, as indicated before, necessitates reshaping our foreign trade policy with a view to encouraging rather than discouraging an expansion of imports.

12–10. Conditions of Payment of Foreign Debts Owed the United States. Payment of interest and repayment of principal, even if extended over 50 years or more, can be made only under the following conditions.

a. Ability to Pay and Willingness to Receive Payments. In the first place, the debtor countries must be able and willing to produce an exportable surplus of goods. These goods must be marketed and the proceeds from their sales made available in dollar exchange for payments to the United States. Foreign debtors can obtain dollar exchange, either directly or indirectly, by increased sales in the United States. Thus real payment will be made possible as a result of our expanded purchases abroad.

Secondly, our willingness to make such purchases is a necessary condition for debt repayment. When real payments on account of foreign debts are once begun on a large scale, it is more than likely that they will be reflected in an unfavorable merchandise trade balance, for it is doubtful whether invisible import items, with the possible exception of tourist expenditures, will increase materially in years to come.

b. American Merchant Marine. The development of our merchant marine during the First World War, and even more so during the Second World War, militates against extensive services being rendered the people of the United States by foreign shipping in the postwar era. At the close of the Second World War, about forty-five million dead-weight tons of ocean shipping (exclusive of laid-up tonnage) were actively operated under the American flag, as compared with about nine million tons in 1939. On the other hand, foreign countries experienced a net loss of about one-third of their ocean-going tonnage during the same interval.

With nearly 60 per cent of the combined estimated world merchant marine tonnage owned by the United States at the end of 1946, there is every likelihood that most of our foreign commerce will be carried on in American bottoms in the immediate postwar era, irrespective of how uneconomical this may eventually prove to be, and regardless of the adverse effects it may have on invisible exports of shipping services of other countries.

National security and prestige have come to be viewed as primary considerations in our maintaining a larger merchant marine after the war than at any time in the past. The Merchant Marine Act of 1936 declared for a United States merchant marine sufficient to meet requirements of national defense and to develop our foreign commerce, which is popularly interpreted to mean our export trade.

In the face of such considerations as these, the likelihood of increased dollar earnings of foreign merchant shipping, which might be used for debt payment in the postwar period, seems rather remote. Furthermore, the ascendency of the United States in international finance will likewise tend to decrease the possibility of large earnings on the part of foreign banking institutions by selling their services to the people of the United States. With the development of our own marine insurance, the possibility of foreign insurance companies rendering us greater services is also diminished.

c. Tourist Expenditures. Tourist expenditures abroad, however, may increase in the future, if travel and living conditions in foreign lands again improve, and if the lure of overseas travel revives in this country. For 1929 these expenditures amounted to upward of 650 million dollars, but in 1938 they had declined to 130 million dollars. Dollar devaluation in 1934 acted as a check on tourist travel abroad. The diminished buying power of the American dollar in countries whose currencies had not depreciated increased the costs of American tourist travel.

The development of overseas air transport may expand tourist travel abroad in the future. But it seems more than likely that any substantial postwar expansion of such travel will be in American aircraft.

There are a number of drawbacks to the growth of American tourist travel abroad that must not be overlooked. The disruption of world currencies as a result of the Second World War will, for some time to come, deter foreign travel because of uncertainties of costs in dollar equivalents in various countries. Again, linguistic barriers and inconveniences incidental to traveling in foreign lands will continue to act as a deterrent to possibly increased tourist travel abroad. Finally, the annoyance of passports, visas, inspections, customs, and all the many petty regulations in various countries detract, to no small degree, from the pleasure of foreign travel. Nor should one overlook as a deterrent to tourist travel the political disturbances in various countries. For these reasons it appears doubtful whether tourist expenditures will offset in the future, to a much greater extent than in prewar years, the items of principal and interest owed us from abroad.

d. Conclusion. The obvious conclusion, therefore, is that if foreign countries, over a long series of years, are going to repay us that which they owe, and we are willing to accept such payment, we must become recon-

ciled to an unfavorable merchandise trade balance of possibly several hundred million dollars annually. In other words, because of the foreign obligations owed to the United States, our trade balance must eventually become unfavorable, if or when the debt payments made by foreign countries exceed our new investments abroad. But under world conditions prevailing in 1948 the likelihood of our acquiring an unfavorable balance of trade seemed remote.

12-11. Methods of Acquiring an Unfavorable Trade Balance. An unfavorable merchandise balance could be acquired in any one of several ways. In the first place, our exports could be kept approximately at the figures which they have attained in recent years, but our imports could be increased materially. For example, the value of our merchandise exports in 1940 was 4 billion dollars, while merchandise imports were valued at 2.6 billion dollars. This favorable trade balance could be converted into an unfavorable trade balance of, say, half a billion dollars annually, by importing commodities valued at nearly two billion dollars more, annually, than in 1940, providing the value of our exports remained about the same. Secondly, our exports could be decreased very decidedly, while at the same time the importation of commodities could be continued at the 1940 level or possibly increased. Finally, both exports and imports could be increased, provided that our merchandise imports could be increased more rapidly than our merchandise exports, until an unfavorable balance sufficiently large to allow for foreign-debt payments to the United States would be realized.

12-12. Obstacles to Acquisition of an Unfavorable Balance of Trade. Each of these means of acquiring an increasingly adverse merchandise trade balance, however, would encounter practical objections. Industries at home, feeling keenly the pressure of foreign competition, would voice their objections to increased importation from abroad; they would bring to bear all the time-worn arguments for a protective tariff. Not only would the continuously unfavorable trade balance be viewed with apprehension, but the increased sale of foreign goods in this country would tend to stir up further agitation for more protection, which might become a popular political issue.

To decrease the value of our exports very materially would do inestimable harm to many of our exporting industries. Our surplus of agricultural and industrial products is constantly seeking new markets. Many of our governmental agencies seem to be making every effort to assist in promoting, rather than diminishing, our export trade. The view is widely expressed that full employment in our postwar economy will depend very largely on maintaining a high level of exports.

The practical obstacles in the way of converting a favorable balance of trade into an increasingly large unfavorable balance are, however, not in-

surmountable. But in the process of readjustment, some domestic industries would undoubtedly suffer from growing foreign competition. On the other hand, foreign countries, bent upon meeting their overseas obligations, will have to expand their industries and their commerce, which, in turn, will mean keener competition for foreign markets. This will intensify business rivalry throughout the world. It will incite American exporters to seek further governmental aid to strengthen them in their struggle with foreign enterprises for world markets. The Webb-Pomerene Act [1] of 1918, legalizing the formation of combinations of American exporters for the purpose of facilitating our export trade, is an outstanding illustration of Federal legislation intended to assist our exporters in their competition with foreign exporters for the markets of the world.

In the final analysis, the problem of making extensive international debt payments resolves itself into a question of ability and willingness to produce, to buy, and to sell. Even if debtor nations of the world were willing to meet their obligations and to increase their industrial output, with which to make payments, the problem of debt payment would not yet be solved. Creditor nations must signify their willingness to buy that which debtor nations have to sell, or to make possible selling their surplus products elsewhere, to provide means with which to make payments. Our apparent readiness to make extensive postwar loans to foreign countries for productive purposes indicates that we are willing to aid in their industrial recovery and development. But to date we have given relatively little indication that we will take the second step, which is equally necessary, *i.e.*, to receive extensive payments in goods on account of foreign debts.

12–13. Recent Obstacles to Change in National Policy. In the decade preceding the outbreak of the Second World War, the United States refused to modify its traditional policy of protection to American industries. The Tariff Act of 1930 actually raised the tariff wall still higher than it was before. The Merchant Marine Act of 1936 granted United States ship operators tax exemption on profits set aside to purchase new vessels; it permitted ship-operating subsidies to equalize operating costs of any foreign competing operator; it also granted governmental subsidies to equalize construction costs between United States–built ships and similar foreign-built vessels of competing foreign operators. Gold-dollar devaluation in 1934 tended to reduce imports still further by raising the paper-dollar costs of foreign goods. In other words, we registered little willingness to accept payments of foreign obligations by encouraging the augmented importation, either of commodities or of services.

Gold-dollar devaluation in the United States in 1934 was of little assistance to foreign debtors in meeting their obligations to the United States. In reality it aggravated their difficulties in obtaining dollar exchange since

[1] Discussed in Chap. XXIII.

it decreased their possibilities of selling their products in American markets or rendering services to Americans. The cheaper American dollar actually militated against American purchasing abroad.

While reciprocal trade agreements, entered into after 1934 with many foreign countries, and the tripartite monetary stabilization agreement of 1936 were designed to stimulate international trade, they apparently have not contributed much toward changing our traditional attitude toward a favorable balance of trade.

12–14. Future Prospects. The problem of debt repayment in our postwar economy will be complicated by the disruption of the prewar exchange rates and the varying degrees of price inflation in different countries. The rates of exchange for various currencies of commercial countries adopted by the International Monetary Fund will have an important bearing on the possibility of debt repayment. If the dollar were to be kept relatively cheap in terms of foreign currencies, it might help to stimulate our exports, but it would make dollar debt payment increasingly difficult, if not impossible. Only as the buying power of the dollar in foreign markets increases relative to its domestic buying power, will imports from abroad be stimulated.

There are no doubt many who still believe that the possible injury to American industries resulting from largely increased imports would be far greater than the benefits to be derived from foreign debt payment. They apparently fail to realize the advantages of foreign investments to both debtor and creditor countries.

12–15. Economic Benefits of Foreign Investments. When a nation invests its surplus funds abroad, as we did extensively on private account during the interwar period, the conditions under which the foreign loans were made were usually specified in the agreement drawn up between the debtor and the creditor or creditors. Frequently the funds realized on the sale of foreign securities to American investors were spent here to purchase industrial materials with which to develop a foreign public or private enterprise. For example, an American manufacturing concern might sell its products to a Chinese railway company, accepting in payment the securities of the foreign corporation, which were marketed, in whole or in part, through investment bankers in this country.

The effect of foreign investments on our export trade is not so obvious when the funds are not spent directly to purchase materials in the lending country. Nevertheless, it is just as real. For example, a group of United States investors may make a loan of 50 million dollars to an Argentine company, with which this company purchases industrial materials in England. The British exporters, who draw dollar exchange in terms of which the loan was made, do so because they know they can sell their dollar exchange for British pounds sterling. But the bankers who buy the

dollar exchange do so because they, in turn, know that someone will buy it from them in order to meet obligations in the United States. These obligations have grown out of purchases made from us. Thus the dollar loan to an Argentine company may be employed by the British in a triangular exchange to pay for American exports.

As a rule, the great lending countries of the world are more industrial than agricultural. When payments of interest and repayment of principal are made, the inflow of imports increases. These imports are largely in the form of industrial raw materials and consumption goods. Because of this increased importation, raw materials in the country receiving payments are more abundant than would be the case otherwise, and the supply of consumers' goods is likewise increased. This will tend to decrease production costs and costs of living in the creditor country, even though domestic capital costs may have been raised somewhat because of the export of capital. The larger imports, made possible by the returns on foreign investments, will tend to raise the material standard of living in the lending country. More goods are made available for consumption because of the foreign investments.

Again, by virtue of the loans made abroad, the borrowing countries, which will normally apply the proceeds of these loans to develop their natural resources and industrial enterprises, will find their production costs decreasing because of the loans. This will tend to increase their prosperity and to give them more purchasing power with which to buy goods abroad. Consequently, it will stimulate further exports from the creditor country.

Thus it may be seen that not merely the original foreign investment, but also the increased industrial output, stimulated by foreign investments, normally tends to increase the exports of the creditor country, while the larger imports, due to debt payment, tend to lower production costs and to raise standards of living.

12–16. Political Implications of Foreign Investments. The economic advantages of foreign investments should not blind us to the political implications of making such investments abroad. Capital-exporting countries, such as the United States and Great Britain, have used their foreign investments extensively to obtain control over undeveloped natural resources in backward countries. An abundant supply of unskilled labor in such territories has also lent itself to such exploitation by foreign capital.

For example, British interests control tin mines and rubber plantations in Malaya, and oil deposits in the Near East, while American concerns own iron mines in Cuba, Chile, and Brazil, and copper mines in Chile. Powerful industrial interests have penetrated backward areas with their investments. In so doing they have generally had strong governmental support to protect their foreign holdings.

It has been said that the flag follows the investor. Economic penetration by private foreign capital with governmental support is commonly referred to as economic imperialism. Such imperialism has been particularly aggressive in the case of oil, because of its vital importance as a strategic war material as well as its peacetime industrial necessity. The political rivalries of the major powers for strategic controls in the Near East at the close of the Second World War were said to smell of oil instead of ideals.

It has been demonstrated that imperialism, because of the costs of protecting empire possessions, has not been particularly profitable to peoples of those nations. But it has been decidedly profitable to the relatively few who have attained control over natural resources that they could exploit because of their foreign investments. If their monopolistic position is challenged by economically powerful groups in other countries, it may become a matter of national honor for such rival imperialist countries to protect the property interests of their nationals abroad. Thus imperialist wars have been unleashed.

"The imperialist ambitions of powerful capitalist interests, backed generally by their respective governments, have been the cause of so many wars that men often speak of 'imperialist wars' as if there were no other kind." [1]

Economic penetration with the aid of foreign capital has contributed to the development of resources in backward countries and has thus undoubtedly helped to raise living standards in such countries. But political domination of the peoples in dependent territories by imperialist powers, growing out of foreign investments, and frequent charges of brutality of foreign exploitation have not contributed particularly either to personal happiness or to the social contentment of dependent peoples.

12–17. The Present Outlook for Future Improvement. Time alone will tell whether the international machinery that is being created by the United Nations will prove effective in controlling the economic rivalries among the powers of the world for the possession of economic resources, rivalries that in the past have frequently led to open warfare. The purpose of the International Bank for Reconstruction and Development is to promote private foreign investments by means of intergovernmental guarantees or participations in loans made by private investors. Moreover, if inadequate to meet recognized needs, the bank seeks to supplement private investment with long-term loans for productive purposes, and to promote long-range balanced growth of international trade with a view to raising productivity, living standards, and labor conditions. The United Nations provides the political structure within whose framework it is hoped that a new attitude toward international economic collaboration may develop in our postwar economy. But judging by the political rivalries among the big powers in

[1] Ise, John, "Economics," p. 563, Harper & Brothers, New York, 1946.

the immediate postwar period, one may entertain serious doubts as to the realization of this hope.

There are those who hold that economic imperialism grows out of the existence of dynamic capitalism which is constantly seeking new outlets for capitalist exploitation by foreign investment. Hence they conclude that not until capitalism is abolished can we hope to do away with imperialist rivalries and imperialist wars. All such viewpoints must be carefully studied and evaluated before reaching any definitive conclusion. The creation of a new political framework for the guidance of peacetime productive foreign investments and the development of intergovernmental controls over the direction of foreign loans give no assurance that the popular attitude toward foreign investments is undergoing a change. Traditional political interests, as well as purely economic considerations, promise to play an important role in the future in shaping the direction and extent of the international flow of capital. Only in the purified political atmosphere of improved international relations may we ultimately be able to realize the many-sided economic benefits of foreign investments without the traditional political implications of such investments.

12–18. "Unproductive" Foreign Investments. When loans are made abroad for "unproductive" purposes, to buy military and naval equipment, munitions, and other implements of destructive warfare in the lending country, they will indeed stimulate exports from the latter, as did our huge loans made to the Allied governments during the First World War and lend-lease deliveries during the Second World War. But to the extent that these implements are employed to destroy rather than to produce peacetime goods, they do not aid in developing foreign natural resources and industrial output, which, in turn, would increase the material prosperity of the borrowing countries. The purchasing power of such countries will consequently be decreased rather than increased by virtue of such loans; and debt payment, under such conditions, must inevitably involve a real hardship to the debtor nations.

If a nation is required to make debt payments abroad for loans of capital funds that were not invested productively, these debt charges must first be collected internally in the form of taxes. If these taxes fall on industries that derived no benefits from such loans, they will tend to increase their production costs. In consequence, the competitive position in world markets of these industries will be weakened by such taxes. Their opportunities of selling abroad, because of their higher production costs, will be diminished. This, in turn, will increase the difficulties of obtaining the necessary foreign exchange with which to pay debts abroad. Hence, it may be argued that collection of internal taxes on the part of debtor governments, with which to make payment abroad on unproductive loans, will actually decrease the possibilities of such debt payments to creditor nations.

12–19. Inter-Allied Indebtedness Growing Out of the First World War. The intergovernmental debts incurred by the countries allied against the Central Powers in the First World War were unproductive investments. The total amount owed by various foreign nations to the United States, as a result of borrowing incidental to the First World War, had a nominal value of almost 14 billion dollars in 1941.

From what has been said concerning productive versus unproductive foreign investments, it should become clear that there is little likelihood that these debts will ever be paid. They were incurred by various belligerent countries chiefly to purchase necessary war materials. They were utilized primarily to destroy, not to build up, industry; they were destructive rather than productive. This is one of the main reasons why cancellation of these debts has repeatedly been urged.

Advocates of debt cancellation, furthermore, emphasized the possible injury to industries in the creditor countries resulting from debt payment. Take the United States, for example, which is both an industrial and an agricultural country. The Allied countries, which are heavily indebted to us, are likewise partly industrial and partly agricultural. The products that they could give us by way of real payments for the cannons, war implements, bombs, munitions, and other destructive machinery are not akin to those we gave to them, for we would not want them. What then could they give? Largely products that are similar to those made by some of our own industries. To the extent that we were willing to accept these products, *e.g.*, textiles, steel rails, motors, surgical instruments, and industrial raw materials, some American industries would find themselves injured because of foreign competition, and the old cry for protection would again be sounded far and wide.

Furthermore, it was argued that we were jointly fighting for a common cause, side by side with our Allies; we should, therefore, share the financial war burden jointly with them. Indeed, a moral issue was made of debt cancellation by pointing out the possibility of creating international good will resulting from a policy of mutual forgiveness of debts arising out of wars.

In the light of the foregoing considerations, it would appear to be sound judgment to write off the inter-Allied debts arising out of the First World War. In so doing, we would merely be applying retroactively the policy adopted with reference to similar intergovernmental obligations incidental to the Second World War.

12–20. Lend-Lease in the Second World War. Our experience with the inter-Allied war debts arising out of the First World War somewhat reluctantly induced Congress to adopt a basically different approach to intergovernmental "lending" during the Second World War. This policy was set forth in the act of Mar. 11, 1941, "to promote the defense of the

United States," popularly known as the "Lend-Lease Act." Section 3 of this act authorized the President "to sell, transfer title to, exchange, lease, lend or otherwise dispose of," defense articles to any country whose defense be deemed vital to the defense of the United States. The significant expression in this empowering clause is "otherwise dispose of."

A net total of defense materials valued at over 35 billion dollars was provided for our Allies during the Second World War. This was more than three times the amount lent our Allies during the First World War. But these "debts" did not complicate the international investment situation, as did the inter-Allied debts arising out of the First World War. Although lend-lease agreements were terminated shortly after the close of the Second World War, the accumulated debts were largely disposed of by "cancellation" or "forgiveness."

Moreover, even while the debts were incurred, their creation did not exert any pressure on foreign exchange markets, for the transfers were made by direct intergovernmental deliveries involving merely accounting records of transactions and no actual transfer of foreign exchange. In other words, our huge wartime net exports of war materials to our allies, notably to Great Britain and to the Soviet Union, did not create an excessive supply of foreign exchange in the United States, which under normal peacetime export trade would have resulted in a decline in foreign exchange rates. Since lend-lease transactions were not financed through ordinary commercial channels and the huge sums involved are being written off as our material contributions to our allies to win the war, they will have practically no effect on our postwar international creditor status.

Only the value of relatively small amounts of materials, delivered under lend-lease agreements after the termination of the war in 1945, has become an obligation of foreign governments to the government of the United States. Great Britain and the Soviet Union have assumed financial obligations on these accounts aggregating about one billion dollars, which will represent only a minor addition to the postwar growing total of foreign indebtedness owed the United States on public and private account.

But although our foreign investments in connection with the Second World War may be disregarded in establishing the extent of our international creditor status in the postwar era and even though the inter-Allied debts owed the United States growing out of the First World War are repudiated or canceled, we will still have to recognize the likely expanding magnitude of our peacetime foreign investments. Unless these are likewise to be viewed as our charitable contributions to aiding in the economic development of the rest of the world, we must understand the full implications of receiving payment and the conditions which will make such payments possible.

12–21. Conclusions. In summary, when real payments of interest and repayment of principal on account of this indebtedness are begun in excess of our new investments abroad from year to year, it is doubtful whether we will be able to continue our favorable merchandise trade balance unless such invisible items as services to American tourists can be expanded materially. There is, however, no reason to view an unfavorable merchandise balance of trade with apprehension. It will merely indicate the normal relationship between a mature creditor country and its international balance of payments; it must inevitably accrue to the benefit of the nation as a whole.

Our governmental policy should be so developed as to facilitate increased importation of foreign products. This may be done (1) by compiling data on possible products which foreign countries have for sale or can produce to advantage; (2) by giving American buyers information, through commerce reports, of favorable markets throughout the world; (3) by lowering tariffs; (4) by continued international cooperation with a view to establishing and maintaining reasonable stability in foreign exchanges.

That some American industries will be injured as a result of largely increased imports cannot be denied. Nevertheless, it would be manifestly unfair to withhold from the masses the benefits to be derived from increased products imported from abroad for the sake of a few industries that may be affected adversely by such importation. After the period of industrial readjustment, there is good reason to believe that the people of the United States will be permanently benefited by an unfavorable merchandise trade balance, even as England has been, from time to time, for nearly a century. But any such economic benefits may be dissipated by the costs of political rivalries arising out of imperialist ambitions of creditor nations. This fact must constantly be borne in mind in seeking to assess the effects of the international flow of capital.

Guide Questions on Text

1. What is the relationship between international trade and foreign investments?
2. Criticize the expressions "favorable" and "unfavorable" trade balances.
3. Trace the several stages through which nations may pass from an international debtor to an international creditor status.
4. Point out some of the economic problems that have grown out of the changed status of the United States from a debtor to a creditor country.
5. Why should our attitude toward exports and imports be modified by our changed international financial status?
6. Account for the decline in our international creditor position during the thirties.
7. "It would be an economically unsound policy for the United States to extend liberal foreign loans in the postwar era merely to maintain domestic employment." Do you agree? Reasons.

8. Analyze the several ways in which debts owed in the United States by foreigners can be repaid.

9. What are some of the obstacles to debt repayment?

10. "Gold-dollar devaluation in 1934 aggravated the difficulties of foreigners in paying their debts in the United States." Explain.

11. Analyze the economic benefits that may accrue to both debtor and creditor countries from foreign investments.

12. What are the basic requisites for realizing the benefits of foreign investments by debtors and creditors?

13. Point out some of the political implications of foreign investments.

14. Distinguish between productive and unproductive foreign loans.

15. Why are war loans commonly viewed as "unproductive" loans?

16. Is there a difference between a productive investment and a self-liquidating investment? Give reasons for your viewpoint.

17. Distinguish between inter-Allied debts growing out of the First World War, and Lend-Lease in the Second World War.

18. Analyze critically the several ways in which the international debts arising out of war loans may be disposed of. Which way do you favor? Why?

Topics for Investigation

1. Relationship between foreign investment and domestic employment.
2. Changes in American export and import markets in the interwar period.
3. Comparison between inter-Allied loans during the First World War and Lend-Lease during the Second World War.
4. Postwar international controls over private foreign investments.
5. Relative importance of invisible items of import as aids to debt repayment.
6. Currency instability and foreign investment.

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CHAPTER XIII

INTERNATIONAL TRADE AND PROTECTIVE TARIFFS

13–1. Protective and Fiscal Aspects of Tariffs. A protective tariff is a duty imposed upon imported articles for the purpose of protecting home industries from foreign competition in domestic markets.

On the other hand, a tariff for revenue is generally imposed on articles entering a country[1] that, even at higher prices, do not compete directly with domestically produced articles; or, if they do, compensating duties are levied on the home products so as to maintain equality of competition. A tariff on crude rubber would be an example of the former, while a tariff on imported cigarettes equal to the excise tax imposed on domestic cigarettes would illustrate the latter.

The fiscal and the protective aspects of a tariff are frequently incompatible. To the extent that an imported article yields revenue, domestic producers are not protected against it. When they are completely protected against competition with a foreign article, it will not be imported at all. As no tariff can be collected if the article is not imported, such a protective tariff will not yield any revenue. However, in view of the popular usage of the term "protective tariff," its use will be retained in subsequent discussion in the sense in which it has been defined above.

13–2. Effects of a Protective Tariff on International Trade. In the analysis of the benefits of international trade in Chap. XI, the unrestricted exchange of commodities and services between the citizens of two countries was assumed, based on the principle of mutual advantage of trade. Such unrestricted exchange is free trade. Artificial restrictions on the free exchange of economic goods tend to lessen the benefits of geographical division of labor.

If a duty is imposed by a governmental agency upon an imported article, that article will normally not be imported unless the benefit derived from importing it exceeds the amount of duty plus transportation charges. To the extent that the duty prevents the consummation of the trade, both the importing and the exporting country will suffer an economic loss. The citizens of the importing country can obtain the foreign article subject to duty only by paying a higher price for it. By offering more of their mone-

[1] It may also be levied on exports, but such duties are unconstitutional in the United States.

tary purchasing power for the article, they reduce the quantity of their purchasing power available to buy other goods.

On the other hand, industries in the exporting country also are affected by the duty. As the sales of their products are reduced because of the import duty on their products sold abroad, foreign producers will have to lower their selling prices or else curtail production. Lowering the selling price in the exporting country will tend to force marginal producers of the exportable article from the field of active competition. Industries injured by virtue of the destruction or reduction of their foreign markets, owing to import duties there, will discontinue or curtail their production. In this process of industrial readjustment available buying power within the country will tend to be diminished, which, in turn, may react unfavorably upon exports from the country that has restricted its imports by means of a protective tariff.

13–3. Protective Tariffs Analogous to Transportation Costs. The economic effects of protective tariffs on the extent of markets are analogous to the effects of transportation costs on trade. Since either buyer or seller must bear these costs, barring governmental subsidies, prices of internationally traded articles will normally show a spread between export and import prices equal to the cost of transportation from one region to another.

The higher the transportation costs, therefore, the larger the difference in the equilibrium price in importing and exporting countries, other things being equal. Moreover, the higher such transportation costs, relative to the export price, the narrower will be the export market. The cost of transportation thus becomes a very important factor affecting the extent of the market and the diversified localization of industry. Other things remaining the same, any reduction in transportation costs will tend to widen markets because of lower possible prices, and vice versa.

While transportation costs represent a payment for a service, yielding income to the factors of production providing the service, artificial restrictions on trade create monopoly advantages for some, often to the disadvantage of others. Even though the outward effects of transportation costs and artificial trade restrictions are similar, they differ significantly in their bearing upon the allocation of the factors of production and the distribution of income.

Trade barriers, whether in the form of protective tariffs, quotas, exchange controls, or any other device, are all restrictions on trade that tend to limit the economic benefits of territorial division of labor by narrowing markets. As the import price of an article is raised by imposing a tariff, domestic production of formerly imported articles may be stimulated and imports retarded. A new equilibrium between the domestic and the foreign price will tend to be established, differing by an amount equal to both the transportation costs and the import duty. But exports will also de-

cline because of the tariff, since the loss of the import market decreases the foreign exchange available in the exporting country to purchase abroad. The country imposing the tariffs will thus increase the costs of imported goods to consumers, with consequent decrease of real income to the latter. Moreover the country that has lost a part of its export market because of import duties on its products abroad will be faced with decreased production, lowering of prices, increasing unemployment or less advantageous employment, and resultant loss of real income.

Barring new opportunities for favorable production, this loss of real income may be permanent in both of the formerly trading countries because of the diversion of the productive resources from more to less advantageous pursuits at home and abroad.

13–4. Effects of Raising Protective Tariffs on Rates of Exchange. Since increased protective tariffs on imports tend to reduce such imports, the demand for foreign exchange in the importing country will be decreased. This would be true even if foreign producers were able and willing to absorb either all or part of the tariff by lowering their export prices. In either case, less foreign exchange with which to pay for purchases abroad would be available to foreigners.

A simple illustration will help to make this clear. Suppose a 50 per cent *ad valorem* [1] duty had been imposed by the United States government on all imports from France some time before the outbreak of the war in 1939. Goods that formerly cost the importer $1 would subsequently cost him $1.50. Unless the French exporter were to cut his price by one-third, he would not be able to continue to sell as much in the United States as before, assuming the demand for his products was not completely inelastic. But by cutting his price as suggested, he would be getting only two-thirds of a dollar. The one-third decrease in dollars available to French buyers in the United States would cause their price to be bid up. It might soon require 33 per cent more French francs to purchase the same number of dollars as before. But if the French importer paid the same price in French francs for American exports as formerly, the American exporter would be able to get only 75 cents for exports formerly bringing in a dollar. If he could not afford to sell at this price, exports would obviously decline.

These effects of protective tariffs on imports might be concealed for a time by extending liberal credit to foreign buyers on the part of the exporting country. Such credits would be analogous to providing the necessary dollars to continue exports without causing an undue rise in the dollar rate of exchange. This was, in essence, the policy of the United States pursued during the "New Era" of the twenties. The tragic aftermath of this policy was experienced during the thirties; its bad effects may continue to be felt in the postwar era.

[1] See footnote, p. 254.

Before attempting an analysis of the many-sided benefits claimed for a protective tariff, let us briefly survey the background of the tariff policy of the United States. Many of the popular arguments reviewed later in this chapter have exercised considerable influence on the development of our tariff policy.

13–5. Development of American Protective Tariff. Our present high-protective-tariff policy is the outgrowth of the Civil War although a certain amount of protection was offered to American industries by the very first tariff act of Congress, in 1789, and defended by Alexander Hamilton in his famous Report on Manufactures.

In general, the tendency in our tariff rates immediately prior to the Civil War was distinctly downward. But in 1864 Congress reverted again to higher rates; for many years thereafter it increased the amount of protection offered to American industries. Congress gradually lowered the internal-revenue duties on articles subject to heavy import duties without reducing the latter. By 1872, nearly all internal-revenue taxes on general manufactures had been repealed.

The Tariff Acts of 1883 and 1890, however, both tended in the direction of higher duties. Slight downward revision in 1894 was superseded in 1897 by a return to a highly protective policy. In 1909 many changes were made in rates, both upward and downward; but, in general, they effected little, if any, reduction in average rates imposed on dutiable articles.

In 1913 the first genuine, downward revision of our tariff in a half century was undertaken. Rates of duties were lowered on practically all articles, and the so-called "free list," *i.e.*, items admitted duty free, was extended.

In 1922 higher tariff rates were again adopted. Rates on raw wool, for example, ranged from 30 to 155 per cent *ad valorem*[1] according to the coarseness of the wool, and from 70 to 110 per cent on woolen yarns. Furthermore, many articles formerly on the free list were returned to the dutiable list, including such products as salt, wool, manufactures of iron and steel, and staple food products. The Tariff Act of 1930 further raised by approximately 20 per cent the duties provided under the Tariff Act of 1922.

13–6. Reciprocal Tariff Act of 1934. In 1934 the Democratic administration approved the Reciprocal Tariff Act, according to which the President might enter into reciprocal trade agreements with foreign countries for a period of 3 years, if existing duties were found to be too burdensome or oppressive.[2] This new law gave the President power to enter into

[1] *Ad valorem* duties are duties levied against the value of imported articles; *specific* duties are based on the quantities of the import items; and *compound* duties are a combination of *ad valorem* and *specific* duties on the same article.

[2] Extended again by Congress in 1945 for a further period of three years.

reciprocal trade agreements with foreign countries and to promulgate such changes in existing tariff rates as were necessary to carry out the foreign trade agreement.

The President was not authorized either to raise or to lower existing duties on imports by more than 50 per cent. Moreover, no article could be transferred either from the dutiable to the free list or vice versa.

The 1934 Act repealed the section of the 1930 Act providing that changes in import duties should equalize costs of production at home and abroad. The principle of reciprocity was substituted for, not added to, that of equalizing costs of production as the basis of tariff making.

In view of the prevailing high rates of protection in the United States today and the possibility of raising, as well as lowering, these rates still further by the President, it may be well to review briefly the many arguments that have been advanced in support of a policy of protection for American industries.

13–7. Infant-industry Argument. Admitting the possibility of immediate economic loss resulting from a protective tariff, advocates of infant-industry protection have frequently pointed to the future economic benefits to be derived from protecting certain industries in their early stages of development against foreign competition. All countries are not in the same stages of industrialization; some have "stolen a march" on other countries that possibly have equally abundant natural resources and an equally efficient labor supply.

Hence, advocates of protection contend that if an opportunity were to be given to establish certain industries at home, they would eventually be able to compete effectively with established industries abroad. Protection is necessary to attract the requisite capital into those enterprises that would not come into existence without protection. When such industries have once been established, it is argued, protection will no longer be necessary.

Many "infants," however, that more than a century ago received protection are unable to stand on their feet today. That some are unhealthy "infants" is reflected in the high rates of protection afforded various textile products under the Tariff Act of 1930. On the other hand, it may be argued that it is their unusually healthy condition that has made possible their getting continued protection.

Some infant industries which originally sought protection and which still enjoy it came into existence during war periods when domestic producers possessed monopolistic advantages because of the temporary cessation or curtailment of foreign competition. Our aniline-dye industry, for example, was developed largely during the First World War because of the absence then of competition from German dyes on our domestic markets.

Many "infants" are feeble children, the product of artificial conditions rather than of natural economic growth. The United States is an industrially developed country today, and the infant-industry argument can no longer be applied in good faith to most of the protected industries. It has been effectively employed in the past to obtain temporary protection; but subsequently other arguments, such as that of vested interests, were advanced by protectionists to continue this temporary protection.

13–8. Diversity-of-industries Argument. Closely akin to the infant-industry argument for protection is the contention that protective duties result in a diversification of industries at home. It is based on the belief that too high a degree of specialization is likely to result in one-sided development of a country, which makes for social maladjustments and excessive dependence on foreign countries. Thus an exclusively agricultural country may, because of lack of diversification of industry, be decidedly backward and unprogressive. On the other hand, a purely industrial country that is too highly urbanized may suffer the ills of modern cities, such as congested tenements and crime-breeding slums. Protection, it is contended, makes for economic independence and a well-balanced national life.

But this argument fails to take account of the economic cost of such diversification. If we assume that the labor and capital of a nation are employed in those industries in which they are relatively most productive, and the country is exchanging its products in accordance with the principle of comparative advantage, then a protective tariff must result in economic loss to that country, because labor and capital will tend to be diverted into less productive channels. Restrictions on imports, as previously shown, will also tend to diminish exports. It is a debatable question to what extent, if at all, these economic losses are compensated for by the prevention of too high a degree of specialization within a nation.

Diversification of industries within a country will be brought about under conditions of free and unrestricted exchange of goods. This is amply illustrated in the United States today, with its textile industries in New England and, more recently, in the South; with its steel industries in Pennsylvania, Ohio, and Indiana; with its automobile industries largely localized in Michigan; and its meat-packing industries in Chicago, Omaha, and Kansas City. All of the many diversified industries within the United States have developed under conditions of freedom of trade between the citizens of our various states.

13–9. Home-market Argument. The home-market argument centers around the idea that the prosperity of the American farmer depends on a continuous and contiguous market for his products that can best be realized by building up manufacturing centers in this country. Foreign markets are not so dependable as domestic markets since they may be wholly or

partially destroyed by political disturbances over which we have little control. The destruction of foreign markets as a result of two world wars emphasized in our own generation the importance of dependable markets to domestic producers.

The home-market argument, in the light of past experiences, attains a certain degree of validity. The economic loss of the benefits of geographical specialization because of a protective tariff intended to develop a home market, again resolves itself into a balance between those losses and the resultant gains of greater industrial stability in times of peace and self-sufficiency in times of war.

Furthermore, it is argued by supporters of the home-market argument that shipping agricultural products abroad and importing manufactures involve double freights for ocean transportation that could be saved by manufacturing at home. The omission in this line of reasoning is obvious. Payment of freights, whether for land or ocean transportation, is more than offset by the savings achieved if goods can be bought and delivered on more favorable terms from a distant market than near home.

If a protective tariff develops certain home manufactures that would not come into existence without protection, another market is indeed created at home for the farmer's product. But it is not an additional market. It is a substitute for the market that was destroyed when our exports were cut off because of the restriction on imports.

13–10. Equalization-of-costs-of-production Argument. Much has been made of this argument in tariff controversies. The Republican tariff platform in 1908, for example, declared:

> In all protective legislation the true principle of protection is best maintained by the imposition of such duties as will equal the difference between costs of production at home and abroad, together with a reasonable profit to American industries.

In 1912, the Progressive party platform contained the following confession of faith: "We believe in a protective tariff which shall equalize conditions of competition between the United States and foreign countries." The Tariff Act of 1930 stressed this principle as the sound basis for tariff making.

Proponents of this argument for protection hold that duties equal to the differences between domestic and foreign production costs should be levied on competitive imported articles. A number of interesting and pertinent questions are raised by the "equalization-of-production-costs" argument, which has been called the "scientific" principle of protective tariffs.[1]

[1] Similar questions of "costs of production" were raised previously in connection with codes of fair competition under the National Industrial Recovery Act. They will recur in subsequent chapters on Industrial Monopolies and Public Utilities.

These questions must be answered in rational attempts to "equalize costs": What is to be included in "costs of production"? Are we to consider the "real" costs or the "money" costs of production? Whose costs of production are to be used as the basis for equalization? Even within the same country different producers in competitive industries have differing production costs, as is witnessed, in part, by different margins of profits per unit of product. This is as true of domestic as of foreign producers. Should average, median, or modal costs of the entire industry in this country or abroad be taken as the basis for comparison; or the costs of the least efficient producer, operating at a loss; or the costs of the marginal firm, operating without either profit or loss; or, possibly, the costs of the most efficiently organized firm making profits? There are as wide variations in costs of production among different producers within the same country as there are between comparable producers at home and abroad.

The Tariff Act of 1930, charging the Tariff Commission with investigating differences in costs of production, did not stipulate either what or whose costs of production it was to consider in making its recommendations. A familiar figure in public life wrote as follows:

> There is, in fact, no such thing as a single domestic cost of production for any commodity. There are almost as many different costs as there are producers; and the question arises, which should be taken for comparison with a foreign cost to find a standard for measuring duties? [1]

The unsoundness of the "equalization-of-costs" argument for protection becomes apparent upon examination. The argument, carried to its logical conclusion, would mean placing a premium on inefficiency. The less efficient our domestic industries became when competing with a foreign producer, the higher the protective duties on the products of competing foreign industries would have to be in order to equalize costs of production. On the other hand, the more efficient foreign producers became and the lower their resultant unit costs, the higher the tariff would have to be to equalize production costs.

This leads to the conclusion that the "equalization-of-production-costs" argument is not only inapplicable in practice, but also unsound in principle. Recognizing the validity of this frequently repeated criticism, the tariff-act amendment of 1934 repealed Section 336 of the Tariff Act of 1930 pertaining to equalization of costs as the basis for tariff duties and substituted therefor the principle of reciprocity in trade agreements. But the popular misconception still prevails that the protective tariff should seek to equalize production costs at home and abroad.

[1] PAGE, T. N., "Making the Tariff in the United States," p. 92, McGraw-Hill Book Company, Inc., New York, 1924.

13-11. Dumping Argument. *a. Currency Depreciation.* This argument was frequently advanced by protectionists in the years immediately following the First World War, when, because of currency inflation in various European countries, exchange rates dropped more rapidly than internal prices of export commodities advanced, making the countries with depreciating currencies good markets in which to buy. In other words, the countries with the low exchange rates were, for the time being, able to undersell their competitors abroad in countries with relatively high rates of exchange. Protection was urged to safeguard our domestic industries against a flood of cheap foreign goods pouring into the country.

Such an expression as "flooding" our markets with cheap imported products is both expressive and impressive. But on investigation the dreaded "flood" often turns out to be not much more than a little surface ripple. For example, the physical volume of German textile products exported to the United States in 1913 was 200,442 tons, while in 1920 it was only 14,274 tons, and still less in 1922, the year of the passage of the Fordney-McCumber Act. The American textile industry, in general, was not severely injured by such a relatively small volume of German textiles imported during the twenties, no matter how low the price may have been.

The fear of "exchange dumping" in the United States was revived in 1931 when Great Britain and a number of other countries suspended the gold standard. The decline in exchange rates of various countries that had suspended gold exports in settlement of trade balances, as noted before, gave an artificial stimulus to exports so long as internal prices did not rise to compensate for the decline in foreign exchange. Japan, in particular, was frequently charged with such dumping, despite the fact that for many years the value of American exports to Japan far exceeded that of American imports from Japan. Exchange dumping invited retaliatory measures in various countries; it has been a disturbing factor in international trade, which emphasizes the need for an international medium of exchange with reasonable stability of value, such as that contemplated by the International Monetary Fund.

b. Surplus Industrial Production. There is, however, another aspect of the "dumping" argument that is of decided importance to highly industrialized countries. It concerns surplus dumping, not "exchange dumping." Many of our large industrial plants, controlling vast amounts of fixed capital, operate under conditions of decreasing unit costs of production. In other words, their total costs of production per unit of output tend to decrease as the number of units produced increases. If the domestic market for their products is such that they can sell only a portion of their industrial output at a price sufficient to cover both fixed and variable costs, with a reasonable profit, any additional output, up to the full

capacity of the enterprise, may be sold in foreign markets at a lower price, sufficient at least to exceed prime or operating costs. Any margin in selling price above such variable costs will mean extra profits to the industry since the domestic prices charged cover the necessary fixed costs. Consequently, industries have, from time to time, resorted to selling a portion of their surplus output abroad at prices below the domestic price.

If this is done permanently, and if similar competitive enterprises are consequently prevented from developing abroad, it is obvious that foreign purchasers will really be the gainers. But if the lower price is charged abroad only temporarily, until foreign enterprises have been driven from the competitive field, and then higher prices are again charged, the problem of protection to domestic industries against such sporadic practices becomes one of paramount importance, which will sooner or later invite governmental interference. The extent to which an industry can resort to these practices will depend ultimately upon a variety of factors, such as the nature of the demand for the product, the possibility of substitution, the existence of monopoly, and the advisability of governmental interferences. Dumping will be treated more in detail in Chap. XXII as a problem of monopoly.

13–12. High Wages and Plane-of-living Argument. One of the most popular arguments advanced by protectionists is that import duties make wages high in the United States and that tariffs are needed to preserve these high wages. In the minds of many people, the high American plane of living can be maintained only if goods made by cheaper foreign labor are kept out entirely or imported sparingly. This common notion that our high wages can be maintained only by means of a protective tariff rests on a misunderstanding of the underlying causes that lead to differences in money wages, price levels, and economic prosperity in general.

Some products of highly paid American labor, such as automobiles, typewriters, and agricultural machinery, compete effectively with the products of "pauper" labor in foreign markets. Even during the world economic depression in 1934, the value of our exported commodities was over 2.1 billion dollars. These goods were underselling the products of foreign labor in the markets of the world; they were competing effectively with cheap foreign labor. Why? Because our labor was more effective in these industries and so received higher wages. This effectiveness of our labor (and not our protective tariff) was one cause of the relatively high wages of American labor.

American wages are high because our labor costs per unit of product are low, while wages in many foreign countries are low because labor costs per unit of product are high. Wage rates per unit of time should not be confused with labor costs per unit of product, as is often done in presenting the high-wages argument for protection. Wages of labor and labor costs

are two very different concepts. The former is a per-unit-of-time concept, but the latter is a per-unit-of-product concept.

b. Money Wages and Real Wages. To be sure, when a particular industry is kept in existence because of the tariff, high American wages could not be maintained in that industry without protection. But the price of the product of such a protected industry is likely to be higher than the price that would prevail if there were no tariff. The labor in the protected industry receives a high wage because the consumers of this product pay a higher price for it than they would have to pay were there no protection.

Unfortunately, the difference between real wages and money wages is little understood by most persons. Even though money wages are higher in the United States than in most foreign countries, unless the larger amount of money received by American labor will buy a larger amount of goods, the American laborer is no better off than the foreign workman. But if his money buys more goods, it is only because there are more goods to buy—and these goods have been produced!

When labor is transferred from a more to a less productive enterprise because of a protective tariff, an inevitable loss in product is sustained. Geographical division of labor is restricted, and as a result of diverting labor into less productive channels, both its general productivity and real wages are lowered. The popular mind, however, does not comprehend this and sees only the injurious effect on money wages in the protected industry if the protection were to be partly or wholly removed.

13–13. Employment Argument. Closely connected with the high-wages argument is the contention that a protective tariff creates employment for American labor, and that the removal of protection would result in increased unemployment. Many workers believe that protective duties increase the demand for labor, for, to the extent that imports are kept out, American labor may be employed to make products formerly imported.

Advocates of this "make-work" argument take only a narrow view of the problem. They do not seem to realize that, as has been stated repeatedly, fewer imports will also mean fewer exports, and therefore while some are employed because of the protection, others, who have been working in exporting industries, will be out of work because of the protective duties.

The fact that a new demand for labor would be created in our export industries as more goods were bought abroad is due to the principle of reciprocity, *i.e.*, imports pay for exports. But this is of little or no significance to those who feel that they would be adversely affected by the removal of protection from their particular products. Here we have a distinct clash between the individual point of view and the social point of view. The latter viewpoint is basic to sound economic analysis.

It may indeed happen that more men will be employed to produce as many commodities as could be had before the imposition of the protective duties, *i.e.*, under conditions of unrestricted international trade. The larger amount of labor employed, however, will not result in a greater flow of consumable goods, which constitutes the real income of the community.

There is in the popular employment argument for protection only a variation of the "make-work" fallacy of production disguised under the cloak of protectionism. Still the belief is widely prevalent that, in the words of former President Coolidge, "protection has contributed in our country to making employment plentiful with the highest wages and the highest standards of living in the world, which is of inestimable benefit to both our agricultural and industrial population." [1]

13–14. Money Argument. One version of this argument, sometimes ascribed to Abraham Lincoln, is contained in the speech delivered by Congressman Randall before the National Tariff Commission Convention, as follows:

> I don't know much about political economy, but I know that when we purchase a ton of steel rails from Great Britain for $100 we get the rails and Great Britain gets the money, and when we produce the rails from our own mines and in our own mills we have both the money and the rails.

The truth of this statement is limited to its opening phrase. The fallacy of this statement is obvious to anyone who has grasped the fundamental principles of exchange. Nevertheless, the quotation, in one form or another, appears repeatedly in protectionist literature; consequently, it must be refuted once more.

In the first place, the money argument is based on the false assumption that the labor and capital, if not employed here in the manufacture of steel rails, would not be employed at all. Secondly, it assumes that dollars paid for rails in England are not going to flow back to this country to purchase other commodities here, in which event we would eventually have both the rails and the money. In the third place, it assumes falsely that we would not buy the rails at home if we could get them more cheaply here than in England, making due allowance for transportation costs. Finally, if this incomplete argument were carried to its logical conclusions, there would be no trade at all within the country, for the best economic interests of the different parts of the United States would be served if each industrial area kept its product and its money at home in order to have both the money and the product.

13–15. Popular Misunderstanding of Money and International Trade. This specious argument, no matter how stated, rests on the common misconception of the significance of money in our exchange economy. It is

[1] *The New York Times*, Dec. 8, 1925, p. 8.

a survival of eighteenth-century mercantilistic doctrine, which confuses money with wealth.

Most of the popularly voiced arguments for protective tariffs are based on similarly fallacious reasoning. As has been previously observed, a mercantilistic bias still lingers in the minds of the masses. They think of exports as bringing money into the country and of imports as taking it out; to them money rather than goods is the desired goal of economic policy.

The many arguments advanced for protective duties are built up around the idea that our national material prosperity depends upon the policy of protection to American industries. If this popular illusion can be dispelled, a decided step forward in the settlement of the complex economic and financial problems arising out of the Second World War will have been taken. Without an understanding of the significance of international trade and of foreign exchange in connection with repayment of our foreign investments or even paying annual service charges on such debts, we can scarcely expect real payments of these obligations to be made.

13–16. Conservation of Our Natural Resources. Proponents of free trade believe not merely that economic loss results from commercial barriers, but also that such restrictions deplete our natural resources more rapidly than would be the case under conditions of unrestricted trade. For instance, pig iron, manganese ore, and many kinds of timber are protected under the Tariff Act of 1930, although this causes the United States to use up these indispensable materials more rapidly than would be true in the absence of protection. The duty on imported manganese ore in 1945 was 39.6 per cent *ad valorem*, and on zinc, an average of 70 per cent.

The Second World War has accelerated the depletion of some of our essential natural resources. It would be in the interest of the entire country to expand our postwar imports of such basic resources as lumber, petroleum, bauxite, zinc, lead, and copper. Moreover, it has been estimated that high levels of employment in our postwar economy will necessitate the importation of double the volume of prewar imports of essential raw materials.

13–17. Protective Tariffs and Trusts. The protective tariff has been referred to as "the mother of trusts." It has been claimed that the higher duties charged on certain imports in 1883, 1890, and 1897 so increased the margin of profit of some domestic producers that it resulted in a reckless duplication of many industrial plants. In order to escape ruinous competition among these domestic enterprises, trusts and monopolistic combinations were formed.

Evidence has been presented from time to time that our policy of protection has encouraged the formation of trusts in the United States. The complaint of the Federal Trade Commission against the Aluminum Com-

pany of America, charging that industry with practices that tend to lessen competition and create monopoly in aluminum in the United States, is a case in point. That this industry was tenderly treated by Congress can be gleaned from the Tariff Act of 1922, which raised the import duty on aluminum from 2 to 5 cents a pound. This latter rate was continued in the Tariff Act of 1930. Such higher tariff rates lessened effective foreign competition and tended to create monopolistic advantages for the domestic industry.

The growth of American trusts and their regulation will be discussed in Chaps. XXII and XXIII.

13–18. Need for Tariff Reform. In the preceding pages the most frequently voiced arguments for and against a protective tariff have been briefly presented. Because of the changed status of the United States from a debtor to a creditor nation, and because of the gradual exhaustion of our essential natural resources, these old arguments in favor of a protective tariff for American industries can no longer be viewed in the light of their former validity or their present popular appeal. The tariff issue must be discussed in terms of present-day realities and the future economic welfare of all trading nations, rather than from an unsound and selfish nationalistic viewpoint.

It would be foolhardy to advocate the sudden removal of our protective tariffs in order to realize immediately and fully the benefits of free trade. "No one would propose that persons, who had in good faith made great investments in plant, on the reasonable supposition of the continuance of the protective policy, should be deprived of the protection suddenly and without notice." [1] The problem of tariff revision cannot be solved overnight. Its solution requires not only time but also a comprehensive program and a definite plan of action.

A stable and sound tariff policy is necessary for the United States. It should not be one that is based on tradition, precedent, political alignment, or fallacious arguments but one that has been developed from a realistic appreciation of the present world situation. Before any permanent tariff policy can be formulated, however, a thorough understanding of the full significance of our present creditor status in its relationship to international trade and the tariff is necessary. This is fundamental if our future tariff policy is to be established on a solid economic foundation.

The problem of formulating a long-run tariff policy requires for its solution expert knowledge and scientific training, as well as painstaking study and thorough analysis. Our tariff problems will not be solved until they are removed from politics and placed in the hands of adequately trained and socially minded persons.

[1] Taussig, F. W., "Principles of Economics," vol. I, p. 543, 3d ed., The Macmillan Company, New York, 1921.

The relationship between international trade and foreign investment was pointed out in Chap. XII. The economic benefits accruing to the people of the United States from extensive payments on the part of debtor nations, in terms of commodities and services, were described. In order to make possible the realization of these benefits, our tariff policy must be shaped with a view to encouraging, instead of discouraging, the importation of goods from abroad. The development of our tariff policy must, therefore, be away from, rather than toward, trade restrictions. A first step in this direction was taken in the Reciprocal Tariff Act of 1934.

13–19. Difficulties of Reciprocal Tariff Agreements. Possible trade benefits to be derived from the 1934 Act should not be exaggerated, for at that time the United States had commercial treaties with most important countries, incorporating the unconditional most-favored-nation clause. This meant that any tariff concession made by the United States to one country in a reciprocal treaty automatically applied to all countries with which we had such most-favored-nation treaty arrangements.

Thus, when a reciprocal treaty between Switzerland and the United States was proposed, in which the United States would lower its tariff on Swiss dyes and chemicals in return for concessions to American products, a storm of protest went up from the American chemical industry. It was alleged that the European dye cartel included not only Switzerland but also Germany, France, Italy, Spain, Great Britain, and Poland. It was maintained that some of these countries would benefit from United States tariff reductions on dyes and chemicals in a reciprocal treaty with Switzerland, without, however, being required to make concessions to American products. This serves to illustrate the chief difficulty in entering into reciprocal trade arrangements, while such a country as the United States adheres to the unconditional most-favored-nation principle.

If the United States alone adhered to the unconditional most-favored-nation principle, foreign countries might be reluctant to enter into reciprocal agreements but might wait for another country exporting similar products to make such a treaty with the United States. They would thus derive the benefits from our tariff concessions without being required to make any reciprocal concessions.

This situation may be illustrated by the reciprocal agreement signed early in 1935 between the United States and Brazil. Under this treaty the United States granted large tariff reductions on mineral and agricultural products from Brazil in exchange for comparable reductions by Brazil on imports of various articles from the United States. The agreement was based on the principle of unconditional most-favored-nation treatment. Concessions in import duties made either by Brazil or by the United States were, *in the absence of special considerations*, to be extended to like products of other countries.

Where the United States feels that it has been discriminated against in matters of foreign trade by another country, it can refuse to extend the trade concession of a reciprocal treaty to that country. This attitude will raise many perplexing issues; it will make for international friction instead of mutual understanding. It is difficult to determine where actual discrimination begins. There may develop, under reservations as to the application of the unconditional most-favored-nation principle made by the United States government, a system of preferential tariffs. Although we may subscribe to the principle of reciprocal tariff agreements, we should not overlook the many practical difficulties involved in putting it into practice. If such reciprocal trade agreements should achieve a gradual lowering of tariff barriers, their beneficial effect may, in the long run, outweigh their immediate drawbacks and dangers.

13–20. A Sound Approach to Tariff Reform. Our tariff problems were solved neither by the Tariff Act of 1930 nor by the Reciprocal Tariff Act Amendment of 1934. Uncertainty as to future tariff rates will continue as long as we do not have a clear-cut national tariff policy. The United States Tariff Commission could render an inestimable service to the country by formulating such a sound and stable policy, which, with appropriate legislation, might be made the legal basis of future tariff revisions.

A future tariff policy for the United States should take full cognizance of our surplus productive capacity, seeking outlets in world markets, as well as of our changed international financial position. Revisions of tariff rates, reflecting a clearly defined tariff policy not subject to political bias or party maneuvers, would tend to eliminate the element of uncertainty growing out of repeated legislative tariff changes, with all their disturbing effects upon business activity.

13–21. Difficulties of Reviving Postwar International Trade. National economic self-efficiency, achieved with the aid of protective tariffs, has frequently been advanced as a peacetime argument for protection. War accentuates self-sufficiency in nations because of its disrupting effect on markets developed in times of peace. Warring nations, as well as neutral powers in times of war, are often compelled to rely on their own resources to meet civilian requirements and to feed the war machine.

In consequence, new wartime industries are developed behind the protective barriers provided by war. The synthetic-rubber industry in the United States is typical of such war "babies." Popular opinion is opposed to dismantling these war industries, representing millions of dollars of investment, even if it could be shown that they were higher cost producers than similar industries abroad. It is almost traditional for us to protect our infants against foreign competition, even after the war is over.

The difficulties of reviving international trade after the Second World War were accentuated by the many changes in relative costs and prices of

internationally traded commodities. Whereas labor costs rose some 40 per cent in the United States during the war, they increased 50 per cent in Great Britain and Sweden and over 100 per cent in France, Mexico, and India. Changes in official exchange rates were far out of line with changes in internal costs and prices. At the close of the war the French franc was very much overvalued externally, a fact that hindered the development of French export trade. On the other hand, the dollar was undervalued, relative to foreign currencies, a fact that reduced the opportunities for foreign countries to sell to us in order to acquire dollar exchange with which to pay for what they have bought from us.

Moreover, the relative importance of invisible items of trade underwent significant changes as a result of the Second World War. The merchant marine of Norway, for example, was greatly reduced. Great Britain lost one-half of her foreign investment and one-fourth of her shipping. In the United States dollar balances accumulated to the credit of those foreign countries that had provided us with essential war materials, while pound sterling balances deposited in London and owed to India and to Near Eastern and South American countries were estimated at 16 billion dollars (at 4 dollars to the pound sterling). The many-sided wartime controls over imports, exports, and foreign exchange, adopted by practically all countries, also militated against the early revival of peacetime trade among the nations of the world.

13–22. Postwar Opportunity. In the light of all these distortions of prewar commercial relations growing out of the Second World War, what should be our policy toward postwar world trade? Should we seek to protect our newly developed wartime industries against "cheap" foreign competition, and revive the time-honored but basically fallacious arguments for protective tariffs? Or should we advocate a downward readjustment of our tariffs all along the line, with a view to encouraging imports as speedily and extensively as possible, so that foreign countries may earn the dollars with which to pay for our exports, rather than continue our gifts abroad under the guise of foreign investments?

An economically sound postwar tariff policy should aim at widespread tariff reductions, not only in our own national interest, but also in the interest of the rest of the world. "Reductions in the tariff would raise our standard of living by bringing about a more productive use of labor and capital within the United States." [1]

The postwar period seems to be an appropriate time to aim at downward tariff revision. The large accumulated wartime monetary demand for civilian goods, expanding markets, and rising prices would tend to diminish the adverse effects of tariff reduction on protected indus-

[1] Slichter, Sumner H., The American Tariff and World Trade, *The Atlantic Monthly*, Dec., 1945, p. 63.

tries, which otherwise would be experienced under more normal conditions.

Moreover, more labor and capital would be reabsorbed in the reconversion period in industries compelled to "stand on their own feet" if tariffs were substantially reduced. But most significantly, by taking full advantage of the productive efficiency of American labor and not placing a premium on inefficiency we would increase the necessity for importation of basic industrial raw materials from abroad and would also be able to export more of our surplus products.

Tariff reductions by the United States could be made a condition for world-wide lowering of trade barriers and removal of exchange restriction. Our strategic bargaining position could be used to revive international trade by creating an economically sound foundation for such trade. This must ultimately be made to rest on the basis of an exchange of goods for goods for mutual benefit and gain. The downward revision of trade barriers, made as rapidly as is expedient, will go a long way toward laying the foundations for peaceful cooperation among the nations of the world.

"Breaking down the barriers which cut off our markets from the rest of the world is the acid test of the country's abandonment of isolationism." [1]

13–23. Expansion of World Trade and Employment. The proposals for expansion of world trade and employment, developed by a technical staff of the United States government, placed the release from many-sided restrictions on trade imposed by governments as a primary consideration on their program. Their proposals were made in preparation for an international conference on trade and employment, held in the fall of 1946 under the sponsorship of the United Nations.

As a means of promoting the expansion of international commerce, an international trade organization was proposed, whose purposes would be to foster international commercial cooperation and, in general, to promote national and international action for the expansion of production, exchange, and consumption of goods, and for the reduction of tariffs and other trade barriers.

In November, 1946, representatives of 17 nations, including the United States, met in London and agreed on the clauses of the Charter for an International Trade Organization (ITO) covering such items as: "development of backward areas, most favored nation treatment, tariffs and preferences, quantitative restrictions and exchange controls, subsidies, state trading, emergency provisions, restrictive business practices and commodity agreements." [2]

The United States thus took a forward step in its effort to establish postwar international trade on a sounder economic basis than that on

[1] *Ibid.*, p. 65.

[2] *The New York Times*, Nov. 24, 1946.

which it had rested in the past. The objectives were clearly formulated, but their realization was by no means assured in the face of the political rivalries existing at the close of the Second World War, rivalries that threatened to pull nations apart rather than weld them together into a cooperative unit. The agreement reached at London, while pointing in the right direction economically, was an agreement among experts but not among nations. The charter of the International Trade Organization was approved by representatives of 53 nations in Havana in 1948. Final ratification by their respective governments, however, was necessary to put it into operation.

Guide Questions on Text

1. Distinguish between a protective tariff and a tariff for revenue.
2. Is a tariff "for revenue only" synonymous with free trade? Explain.
3. Analyze and illustrate the effects of protective tariffs on the volume of a nation's exports and imports.
4. "Protective tariffs are analogous to transportation costs." Explain and illustrate.
5. In what important respect do transportation costs differ from protective tariffs in their effect on international trade?
6. Show how the imposition of protective tariffs tends to alter existing exchange rates between two trading countries.
7. Trace the development of the protective tariff policy of the United States prior to and after the First World War.
8. Point out the essential features of the Reciprocal Tariff Act of 1934.
9. Analyze critically the "infant-industry" and "diversity-of-industries" arguments for protective tariffs.
10. "The home-market argument for a protective tariff, in the light of past experiences, attains a certain degree of validity." Do you agree? Give reason for viewpoint.
11. Evaluate critically the "costs-of-production" argument for protection.
12. What is meant by "dumping"? Under what conditions is "antidumping" legislation warranted?
13. Point out the basic fallacy in the contention that a protective tariff is necessary to protect the American standard of living of wage earners.
14. Analyze the "employment" and "money" arguments for protection.
15. What is the relationship between protective tariffs and (*a*) natural resources, (*b*) trusts?
16. "The tariff question must be viewed in the light of present-day realities and the future economic welfare of all trading nations." What does this statement imply?
17. What do you consider the basic requisites for an economically sound tariff policy for the United States?
18. "It is easy to exaggerate the benefits of reciprocal tariff agreements." Do you agree? Reasons?
19. Point out the difficulties confronting the nations of the world, seeking to revive postwar international trade.
20. Evaluate the proposals to expand postwar world trade through the International Trade Organization.

Topics for Investigation

1. Importance of export markets to various American industries.
2. Study of economic effects of reciprocal trade agreements with specific countries.
3. Effects of specific import duties on costs of products to consumers.
4. Analysis of procedure in fixing specific tariff rates.
5. Steps in the development of the International Trade Organization.
6. New domestic industries fostered by conditions of global war.

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Part Five

PROBLEMS OF PUBLIC FINANCE

CHAPTER XIV

PUBLIC EXPENDITURES

14–1. What Is Public Economy? Public economy consists of the efficient utilization of scarce economic resources by governmental agencies, with a view to maximizing social benefits and minimizing social costs. It differs essentially from private economy in that it is guided by considerations of general welfare, public needs, and social control rather than by competitive market forces based on individual freedom of choice and action. The distinction between public and private economy cannot always be sharply drawn, for public utilization of scarce productive resources will of necessity affect their availability and hence their costs for utilization by our private-enterprise economy. Moreover, various regulatory activities of governments, involving public expenditures in the public interest, as will be shown later, will indicate the direction taken by private economy. Thus there is a definite interrelationship between public and private economy.

Since the shaping of public policy is influenced by broad social considerations, questions of politics as well as of economics must be weighed in an analysis of problems of public economy. Although the following treatment of problems of governmental expenditures and receipts, which measure the flow of our national income through public channels, will place primary emphasis on the economic aspects of the problems involved, this should not cause the student to lose sight of their political significance. In such a democracy as ours a high degree of freedom of choice rests with the people, both in political and in economic matters, even though there are obvious differences between political freedom and economic freedom. One economist has gone so far as to suggest that the expression "free enterprise" be kept "to describe a state of freedom for both kinds of enterprise [public and private] on fair terms which, in each particular case, permit that form to prevail which serves the public best." [1]

14–2. Nature of Public Finance. An examination into the various sources of public funds to finance public expenditures and their administration forms the subject matter of public finance. It is an integral part of

[1] LERNER, ABBA P., "The Economics of Control," p. 87, The Macmillan Company, New York, 1944.

the study of economics, for it deals with providing the means to gratify the most insistent human wants with the aid of scarce resources.

Some human wants are gratified individually, while others are gratified collectively through a governmental agency. No sharp line can be drawn between them. Protection to person and property may be secured by carrying weapons for defensive purposes and by providing homes with burglar alarms and safety vaults, while, on the other hand, reliance may be placed chiefly upon police protection to afford this security. The desire for an education may be gratified either by employing private tutors or by attending public schools. Similarly, employment to earn a livelihood may be furnished either by private enterprises or by governmental occupations.

In order to gratify human wants, individually or collectively, economic goods are necessary. Both public and private finance deal with providing the pecuniary means to obtain possession of economic goods. Inasmuch as the value of economic goods is usually measured in terms of money, receipts and expenditures of funds, whether public or private, indicate the extent of control over economic goods that are used, directly or indirectly, to gratify human wants.

Public finance, moreover, is a part of economics because of its influence on the production, distribution, and consumption of wealth. When public funds are employed, either to aid private industry or to carry on public productive enterprise, definite direction is given to certain productive activities.

Furthermore, when the effects of securing revenues in different ways are considered, some definite theory of distributive justice must be held in mind. The popular slogan "soak the rich" is indicative of a taxation policy that appeals to the masses. Again, when a governmental agency places a sufficiently heavy tax on a so-called "luxury," it can definitely limit the consumption of such a commodity. Taxes on that portion of the national income normally spent to buy consumers' goods, in general, will tend to decrease the demand for such goods and thus affect their consumption. Hence any program of taxation affects the distribution of income and the consumption of economic goods.

Again, the funds obtained by governmental agencies from various sources are expended for different purposes. The general direction and extent of these expenditures will, in turn, influence the nature of the productive activities of private business enterprises.

The economic significance of public finance, therefore, should not be lost sight of; economic principles governing the production and evaluation of economic goods are basic to the study of public finance.

14-3. Differences between Public and Private Expenditures. There are several basic differences between public and private expenditures. Public expenditures are made to promote the general welfare, to create

legal security, to maintain peace and independence, and to aid in the development of the economic life of the people as a whole. Private expenditures, on the other hand, are usually made to gratify the desires of an individual, either directly or indirectly.

Again, while many services rendered by a governmental agency cannot be individualized and separately evaluated, private expenditures are made in exchange for specific services, an appropriate payment being made for every service rendered, based on mutual benefit to buyer and seller. As a rule, no special payment is made for services rendered by the government to individuals, since such special services are intended to accrue to the benefit of all. Readiness to serve, such as police and fire protection, obviously cannot be individualized. Public expenditures are made to provide public services; while in private finance, expenditures are commonly made to realize personal profits.

A further difference between public and private expenditures is that it is generally impossible in public finance to compare costs of production with value of product because of the nonmaterial nature of many services rendered. In private finance, costs of production, in the long run and under competitive conditions, determine the value of the product.

Another difference arises out of the fact that government agencies regulate their income by their expenditures, while private individuals ordinarily regulate their expenditures by their income. Public needs are first determined, after which governments proceed to ascertain how much will be required to finance them; then the state sets about to devise ways and means to obtain the necessary funds to meet these requirements.

14–4. Modern Tendencies in Public Expenditures. The expansion of governmental activities and rising public expenditures in our present-day economy run counter to the traditional attitude toward a limitation of state functions in a democratic society. With the gradual abolition of political absolutism and an increasing tendency toward constitutional government, it was believed by many that public expenditures would decrease. Mercantilism, as a governmental policy, was replaced by a laissez-faire attitude in the eighteenth and early nineteenth centuries, when the idea prevailed that the government which governed least would govern best—hence, the frequently expressed belief that governmental activities would diminish and governmental expenditures would decrease. But this prediction has not come true, for one of the striking characteristics of public finance during the last century and a half, not only in the United States but similarly in every civilized country, has been the rapid growth in governmental functions and in public expenditures. How are we to account for this development?

In the first place, the many economic changes wrought by the Industrial Revolution must be borne in mind. The introduction of the factory system

and its intensification of specialization resulted in a rapid growth of towns and cities, necessitating increased governmental regulation of industry, in particular, and of social relations, in general.

Furthermore, the increased productivity resulting from the use of power machinery made possible the support of ever-increasing numbers of people. Population throughout the civilized world multiplied rapidly in the last century and a half. In 1790 the population of continental United States was but 3,929,214; in 1940 it was 131,669,275. Europe in 1800 had an estimated population of 187,000,000; in 1940 this number had increased to 402,800,000 (excluding the U.S.S.R.). Such a rapid growth of population was made possible by the remarkable development of the arts of production and the opening up of new territories to commerce and industry. Increased governmental expenditures naturally followed this phenomenal increase in population and wealth.

With the increase in population and economic interdependence, as a result of the industrial development of the last 150 years, human desires that could best be gratified collectively likewise multiplied. Increased governmental regulation of economic activities became increasingly necessary. This fact in part accounts for the rapid growth of certain items of public expenditures.

Economic changes brought about by the introduction of the machine process reacted upon existing social and political institutions, and these, in turn, also underwent profound modifications. Practically all these changes resulted in increasing the sphere of governmental activities, which were gradually enlarged "to embrace not only protection from internal disorder and foreign aggression, but also public education and health, public works, provision for spiritual as well as physical advancement, and other related activities." [1]

14–5. Increase in Public Expenditures. *a. Federal Expenditures.* Table 7 compares the increase in Federal expenditures at ten-year intervals since 1910, and for 1943, with estimated increases in national income. These figures have not been refined for changes in the level of prices since 1910. While in 1910 only 2.2 per cent of the national income was represented by Federal expenditures, this figure rose to 11.6 per cent in 1940, the last full year prior to our entry into the Second World War. In the midst of the war, in 1943, it totaled 67.1 per cent of the estimated national income of that year.

While Federal expenditures (exclusive of debt retirement) declined significantly after the war, they nevertheless were around 41 billion dollars in 1947, or 21 per cent of estimated personal income for that year. In the revised national income estimates made by the Department of Commerce

[1] "Taxation and National Income," National Industrial Conference Board, *Report* 55, p. 10.

in 1947, the personal-income data correspond very closely with earlier estimates of national income given in Table 7.

Chart 7 illustrates graphically the growth of Federal expenditures from 1915 to 1947. The significance of the Second World War is apparent.

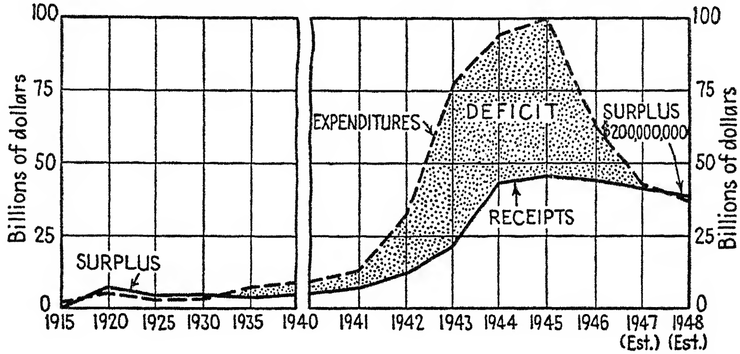

CHART 7. Effect of depression and world war on Federal expenditures. (*Courtesy of The New York Times.*)

TABLE 7. INCREASE IN FEDERAL EXPENDITURES IN THE UNITED STATES, 1910–1943 *

Year	Population	Federal expenditures (exclusive of debt retirement, current dollars)	Estimated national income (current dollars)	Per capita income	Per capita Federal expenditures	Ratio of expenditures to income, per cent per capita	Wholesale price index (1910 = 100)
1910	91,972,266	$ 693,617,065	$ 31,430,000,000	$ 342	$ 7.54	2.2	100.0
1920	105,710,620	6,403,343,841	74,200,000,000	702	60.10	8.56	219.3
1930	122,775,046	3,440,268,884	77,300,000,000	622	28.02	4.51	122.7
1940	131,669,275	8,998,189,706	77,574,000,000	589	68.35	11.6	111.6
1943	136,485,000	93,743,513,214	148,000,000,000	1,084	686.84	66.9	146.5

* Compiled from *Statistical Abstract* of the United States, 1943, and *Annual Report,* U. S. Treasury, 1944.

b. State and Local-government Expenditures. Not only Federal expenditures but also those of state and local governments have grown rapidly during the present century. Per capita state governmental expenditures quadrupled, from $4.06 in 1913 to $16.84 in 1934, while per capita local expenditures more than doubled, from $19.10 to $48.62, during the same interval. In 1941, per capita state governmental cost payments had risen to $22.92, while local government outlays aggregated $49.53 per capita. These estimates also are in current dollars.

14–6. Refinement for Changes in Prices. One must not lose sight of the fact that during the past 45 years the purchasing power of money has changed materially from time to time. The level of prices in 1947 was more than double that of 1900. Increased public expenditures do not necessarily

mean increased public services rendered, and decreased expenditures do not imply curtailed activities of the government. Increased public services may be rendered with the same, or even a somewhat decreased, public expenditure in a period of falling prices. On the other hand, greater public expenditures in a period of rising prices may be required to provide the same or even less public services. If our postwar price level should continue considerably higher than the prewar level, which is very likely as a result of wartime currency inflation, larger governmental cost payments will be required to provide merely the ordinary prewar governmental services.

14–7. Causes for Growth of Public Expenditures. In addition to the decline in the value of the dollar, four major causes may be cited for the general upward trend in public expenditures, particularly since the turn of the present century: (1) costly wars and expensive peacetime military and naval equipments; (2) peacetime emergencies, such as a severe depression, inviting both direct relief expenditures and the expansion of public works programs; (3) increasing urbanization, multiplying the number of social needs that necessitate larger public expenditures; (4) increased governmental policing and regulatory activities.

14–8. War Expenditures. Most important among the causes of increased governmental expenditures have been outlays for war purposes. From the beginning of the twentieth century until the outbreak of the First World War, aggregate Federal expenditures for national defense were constantly increasing; but in relation to total Federal expenditures they were decreasing slightly. The First World War, however, caused a decided increase in military and naval expenditures.

Although the large aggregate direct disbursements for war purposes, amounting to over 18 billion dollars in 1918–1919, showed a substantial decline after 1921, the expenditures for national defense by the War and Navy Departments and the payments of pensions and interest on public debts arising out of the First World War amounted to upward of 1.2 billion dollars in 1929, or nearly double the total ordinary expenditures of the Federal government in 1910.

A somewhat similar relationship between pre–Second World War and postwar annual Federal expenditures may be anticipated, after the transition to a peacetime economy has been made; debt service charges alone will approximate 70 per cent of the average annual prewar Federal ordinary expenditures of around 8 billion dollars. Annual postwar military expenditures by the Federal government have been variously estimated at between 5 and 6 billion dollars, while pensions for veterans will probably involve several billion dollars more. Thus these annual costs arising out of war and national defense may amount to double the total prewar Federal expenditures at 1945 prices.

Advocates of national defense hold to the doctrine that the best assurance for peace is to be constantly prepared for a war emergency. This theory, however, has not been substantiated by fact, for the First World War climaxed the ever-increasing expenditures for preparedness on the part of European countries prior to 1914. Again, in the decade before the Second World War, expenditures for military "defense" throughout the world were several times greater than just prior to the First World War. The increasing costliness of peacetime armaments, aside from humanitarian and moral considerations, is a major factor in the quest for an end to wars, which finds expression in the high hopes placed by many in the United Nations. But the belief in peacetime national military defense expenditures as a basic necessity is still an important determinant of national policy at home and abroad.

14–9. Costs of the First and Second World Wars. The heavy costs of the First World War upset many previous calculations of military costs. The combined direct money costs of all important European wars of the nineteenth century have been estimated at about 14.5 billion dollars, while the net direct money costs of the First World War to the warring nations have been placed at 186 billion dollars, or more than twelve times the money costs of all European wars of the nineteenth century. Even when the money costs of the First World War are estimated in terms of stabilized dollars, they are nearly six times as great as the costs of all European wars of the last century.

Nor does this figure take into account the continued cost of interest payments on war debts and provisions for war veterans. As of June 30, 1934, the estimated money costs to the United States government alone, arising merely out of the First World War, amounted to 41.5 billion dollars. This estimate, however, was based on the erroneous assumption that inter-Allied war debts owed to the United States would eventually be paid. Since there is little likelihood that they will ever be honored, the actual total money costs of the First World War to the United States will ultimately be well over 50 billion dollars.

But while the costs of the First World War stagger the imagination, those of the Second World War are beyond human comprehension. For the fiscal year from June, 1942, to June, 1943,—our first full year of the war—expenditures by the Federal government exceeded 70 billion dollars, or more than three times the total net Federal expenditures in prosecuting the First World War in 1917–1918. In the subsequent two years of the Second World War Federal disbursements rose to over 90 billion dollars annually, or to more each year than the total money value of the national income produced in 1939.

When final figures of the money costs of the Second World War are compiled, they will very likely be found to be eleven times greater than those

of the First World War. These costs are not expressed in inflated dollars, as compared with the 1918 value of the dollar. The wholesale commodity price index, which at the end of the Second World War stood at 105.5, was 131.3 in 1918 (1926 = base 100). Thus the price index was 24.5 per cent higher in 1918 than in August, 1945. Actually the United States used ten times more of the national wealth (almost seven times in current dollars) to win the Second World War than the First World War.

According to immediate postwar estimates, the Second World War will have cost the United States 336 billion dollars, when all the direct war-cost

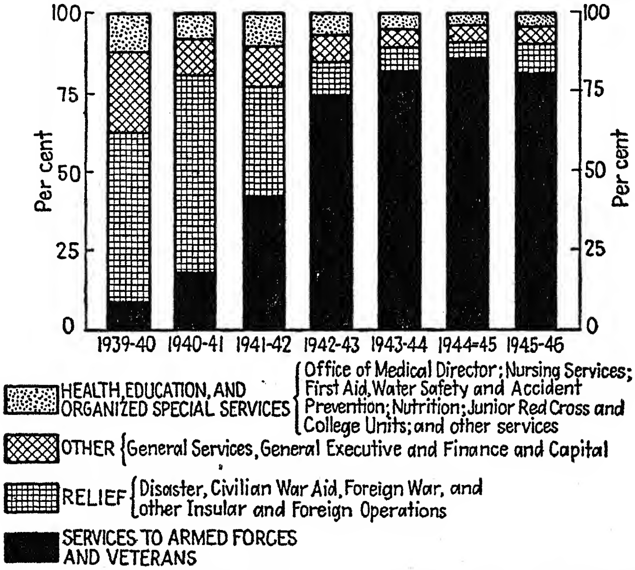

CHART 8. National expenditures for services to the armed forces and veterans have become increasingly a larger part of the total. (*Courtesy of The New York Times.*)

bills have been paid. These dollars measure, in part, the value of mineral resources depleted, forests denuded, oil reserves used up, mines worked out, capital deteriorated, and monetary compensation for those killed or injured in winning the war. The dollar outlay amounted to nearly twice the total Federal government expenditures in 151 years of its existence prior to 1940.

Not all these wartime governmental disbursements went directly for the merchandise of death. Thus, during the Second World War the Federal government spent about 28 billion dollars for war construction, some of which lends itself to peacetime civilian use. Moreover, 118 billion dollars were spent for nonmunitions, but by far the major portion of the total Federal wartime outlay, 195 billion dollars, was spent for instruments of destruction in one form or another [1] (see Chart 8).

[1] *United States News*, Aug. 24, 1945, and Sept. 7, 1945.

These staggering totals should be borne in mind in comparison with the rise in public expenditures to finance public assistance, of one type or another, during the depression following the stock-market crash of 1929. Great though the latter expenditures were, in an absolute sense, they were rather small when compared with war costs. Moreover, they represented government outlays to save lives rather than to destroy lives.

14–10. Public Assistance and Public Works Projects. For the fiscal year ending June 30, 1940, Federal expenditures arising out of the depression of the thirties amounted to around 1.6 billion dollars. As indicated in Table 7 on page 277, the per capita total expenditures of the Federal government more than doubled in this single decade, rising from $28.02 in 1930 to $68.35 in 1940.

This increase in Federal outlays growing out of the depression of the thirties invited much unfavorable criticism of such lavish governmental spending in a period of peace. Costs of this domestic struggle against unemployment and poverty were frequently compared with the costs of the First World War. Several points, however, should be borne in mind in comparing war expenditures with public employment and relief expenditures in times of peace. War expenditures are chiefly for destructive purposes, and so result in a net economic loss to society although individuals may reap profits in a war economy. Public assistance expenditures, on the other hand, are intended to preserve life and to maintain the morale of the unemployed during periods of involuntary idleness. They are commonly made, moreover, to expand useful civil and public works. Finally, funds made available by the Federal government to finance public works and to increase employment are often invested in such self-supporting projects as power plants, housing developments, and the like. The proceeds derived from the sale of the services of these projects may suffice not only to operate the projects effectively but also to repay the investment over a period of years.

Moreover, these expenditures add to the productive assets of society, even as do private investments. Production consists of creating want satisfaction in economic goods. Governments are productive agencies. Expansion of productive activities of governments during a period of mass unemployment may be necessitated by retardation of private business activity. The alternative to such public outlays may mean idle productive resources and economic waste. Peacetime public enterprise should therefore be designed to augment private enterprise with a view to maintaining high levels of productive employment at all times. This will make it possible to minimize the loss to society resulting from involuntary idleness. The following chapter will consider the economic consequences of government borrowing to finance public expenditures for both peacetime and wartime purposes.

Governmental expenditures for war purposes are wasteful and uneconomical; they can be eliminated only by the abolition of wars and by re-

moving the causes of wars. Although public assistance outlays to relieve conditions created by economic depressions are not so wasteful as war expenditures, they too can be reduced only by the prevention of such depressions.

Those who protest against mounting governmental expenditures and increasing governmental encroachment on the field of private enterprise during depression years should face the following facts fairly and squarely. Government outlays are made, in general, to promote the well-being of society, which is seriously impaired during periods of mass unemployment. Whenever private enterprise fails to provide high levels of productive employment to meet the ever-expanding economic wants of members of society, it becomes the function of government to aid in achieving this goal.

There is, however, no general agreement, even among economists, as to the best and most efficient method of providing this assistance. While some favor direct governmental participation in economic activities by means of carefully planned and properly timed public works projects, others would have the Federal government, in particular, use merely its regulatory and taxing powers to create the "healthy" atmosphere for private enterprise to operate at stable high levels of productive employment at all times.

Such an atmosphere could be provided, it is maintained, if restrictive tax legislation on private enterprise were removed, monopolistic practices curbed, and government budgets balanced. Laudable as these objectives may be, their realization seems rather remote in the face of present-day realities. There is no indication that we will not again be confronted with periods of private business recession in our postwar economy, when governments will have to provide an expanded program of public assistance if we would maintain full utilization of our productive resources at all times. As far as possible, public assistance and public works should be so planned as to integrate with the fluctuations of private business activity.

14–11. Socialization of Consumption and Regulatory Functions of Governments. A large portion of the increased public expenditures of state and local governments is the result of a shift from individual to collective consumption owing to the increasing complexity of modern society. It includes increased outlays for public health and sanitation, education, public safety, maintenance of streets and highways, and public charities.

The upward trend in local-government expenditures for collective needs during the present century was retarded somewhat during the depression of the thirties, while state expenditures continued upward. The many-sided costs of governmental services, rendered by state and local governments, are indicated in Table 8.

Public regulation of various enterprises known as public utilities, governmental supervision of banking, enforcement of security and exchange

legislation, administration of social security, and many other forms of governmental regulative activities are making increasing demands upon public funds at all levels of government. There is little question about the importance of these essential public services; nor could individuals perform them adequately for themselves. Modern city life, for example, would soon be disrupted were every resident to provide for his own police and fire protection, his own sanitation and sewage disposal, his own education, and

TABLE 8. EXPENDITURES OF STATE AND LOCAL GOVERNMENTS, 1941 *

(Dollar items in millions)

Functions	State	Local	Total	Per cent of total
Cost payments: Total	$3,072	$6,637	$9,709	100.0
Schools	274	2,238	2,512	25.9
Highways	848	823	1,671	17.2
Old age and unemployment insurance	486	3	489	5.0
Welfare	485	740	1,225	12.6
Health and hospitals	315	284	599	6.2
Corrections	86	65	151	1.6
Sanitation		291	291	3.0
Police and fire	131	581	712	7.3
General administrative, legislative, and judicial	190	601	791	8.2
Interest	111	456	567	5.8
Recreation	15	171	186	1.9
All other	131	384	515	5.3
Debt retirement	238	615	853	

* U. S. Department of Commerce, Bureau of Census, "Financing Federal, State and Local Governments, 1941," p. 54.

his own protection against contagious diseases. The important consideration is whether or not the increasing number of tax dollars applied to rendering useful and necessary public services are spent efficiently to yield the maximum public benefits. Frequently too much criticism is made of the increasing burden of taxation, and too little thought is given to the collective benefits derived from increasing public expenditures arising out of the growing complexities of modern life.

14–12. Limit of Public Expenditures. Causes for the general upward trend in public expenditures have just been sketched. An attempt to justify such increased expenditures requires an analysis of legitimate functions of government. Various writers holding divergent views concerning the proper scope of governmental activities have expressed them-

selves differently as to the limit of public expenditure. Some have attempted to fix it as a certain percentage, ranging from 5 to 25 per cent of the total annual income of the nation. Others have attempted to estimate "proper" governmental expenditures on a per capita basis.

It seems doubtful, however, whether any such arbitrary method of fixing a "proper" amount for public expenditures is possible. In the final analysis, all governmental costs must be justified on the basis of social necessity and also be examined in the light of political expediency.

14–13. Expansion of Public Expenditures with Increasing Governmental Activities. As previously indicated, construction of public highways, provision for public education, protection of life and property, which are becoming ever more involved, particularly in our concentrated urban areas, all serve to illustrate the constantly increasing need for additional peacetime public expenditures. Without entering into a detailed theoretical analysis of the functions of modern governmental agencies, it may be accepted as a working hypothesis that, in general, proper public expenditures are those which are normally made by governments today, and that each extension must be judged on its own merits.

Such an approach must be taken in judging the soundness or unsoundness of the large public assistance expenditures of the Federal government during the depression of the thirties. It can be argued that if government had not intervened with its large public expenditures in one form or another, normal recovery would have followed naturally instead of being stimulated artificially. The government was confronted with a critical situation, to which it responded with action, which may have been wise or unwise, consistent or inconsistent. Since private enterprise was not developing the necessary productive activity to meet the national crisis, it devolved upon government to do so.

A somewhat similar attitude may be taken toward governmental outlays for war. As long as nations engage in warfare to settle international differences, war costs must be accepted as a proper public expenditure. Only as nations, through appropriate international organization, can devise means other than war to settle their differences, will it be possible to remove a major item of public expenditures from governmental budgets.

It must be reiterated that governments are productive agencies in modern society. Even expenditures for war are productive, in the sense that they provide want satisfaction in economic goods. But they can scarcely be viewed as economical, for it is not beyond the ingenuity of man to devise less wasteful uses of scarce productive resources than for warfare to settle international disputes. The "proper" amount of public expenditures at any given stage in the evolution of our political and economic institutions should be gauged on the basis of the utility to the com-

munity that such expenditures provide. As peacetime economic, social, and political institutions increase in complexity, the number of desires that can best be gratified collectively by a public agency will also increase. This generalization is expressed in the law of increasing public expenditures.

Comparisons between different countries and different periods show regularly among progressive nations an extension of public activities. This manifests itself extensively and intensively. The state and its subordinate political units continually undertake new functions, and they perform their duties, old and new, better and better. In this way, *i.e.*, through public agency, the needs of the population, especially their common needs, are satisfied to an increasing extent; and the public services for the satisfaction of needs continually improve in quality. The clear proof of this is given statistically in the increased demands made by the state and the subordinate political units.[1]

14–14. Budget Control of Public Expenditures. Since public expenditures have been absorbing a constantly increasing share of the national income, their efficient control is a matter of paramount importance to all citizens in our democracy. It is the taxpayer who ultimately must pay the costs of government. Effective control over expenditures is facilitated with the aid of governmental budgets.

A budget is a plan for financing a governmental agency or a private enterprise during a specified period of time, usually a year. A governmental budget may be prepared either by a responsible executive and then submitted to a representative body for review, possible revision, and final approval; or, it may be prepared directly by the legislative body. The preparation of a budget involves a careful analysis of public expenditures and their balancing against present and anticipated receipts. If the expected receipts to meet budgeted expenditures are derived from public revenues and do not include loan funds, the budget is said to be balanced. On the other hand if, for one reason or another, the estimated revenues fail to cover the actual expenditures in the budgeted period, the budget becomes unbalanced.

A budget officer, a bureau, or a commission responsible to the executive may be charged with drawing up the budget plan. In the case of the Federal government, the President prepares the budget estimates, but members of Congress have the constitutional power to introduce appropriation and taxation bills. In the separate states the legislatures likewise retain the right to initiate revenue legislation.

Once a budget has been officially adopted, it serves as the directive for the orderly and systematic financial management of the affairs of a governmental agency. A budget is an effective device for controlling public

[1] WAGNER, ADOLPH, "Grundlegung der politischen Oekonomie," 3d ed., vol. 1, p. 893, (Authors' translation).

receipts and expenditures; and, if adhered to by the responsible public administrators, it becomes the all-important basic instrument of accounting control over governmental income and outgo. Good budgetary practice tends not only to check governmental extravagance, but it may also prevent possible dishonesty in administering public funds.

14–15. Traditional Attitude toward Public Expenditures. As a rule, relatively little consideration is given by the layman to the study of public expenditures. The average citizen is concerned primarily with the burden of taxation imposed upon him; he is apt to favor that governmental agency which makes only slight demands upon his individual income and is out of sympathy with the governmental unit which imposes heavy burdens of taxation upon him.

It is regrettable that the expression "burden of taxation" has attained such general acceptance. To a great many persons every tax is a "burden." Yet if viewed in the light of a cost payment, it becomes apparent that a tax is, in reality, a payment for a governmental service.

The "burden" should be related in the mind of the taxpayer to the collective benefits derived from public expenditures. If the alleged service is one that does not seem to warrant the expenditure, the taxpayer must be free to voice his disapproval. This is the distinct privilege of a citizen of a democracy such as ours. But such judgment should be based on a better understanding of the nature and functions of public expenditures than has apparently prevailed heretofore.

It is essential that more attention should be given to governmental expenditures, and that the citizens of each community should obtain a more intelligent grasp of the significance and purpose of such expenditures. "When the average citizen is as careful about how public funds are spent as he is about spending his private salary we will not hear any more about government extravagance." [1]

In former years it was almost impossible for the average citizen to obtain accurate information concerning public expenditures. As a result of the adoption of budgets by various governmental agencies, however, and of the wide publicity given to such budgets, the situation has markedly improved. Budgeting laws have been adopted not only by the Federal government, but also by all 48 states and by many municipalities. As a result of the general publicity given to proposed governmental financing, those citizens who are sufficiently interested are given an opportunity to exercise their own judgment on the proposed expenditures. They may urge or question the expediency of farm subsidies, soldiers' bonuses, military expenditures, "deficit financing," and the like. Legislators' approval or disapproval of governmental expenditures is greatly influenced by the views of their constituents.

[1] MELLON, ANDREW, *Nation's Business*, Nov., 1923, p. 14.

14–16. Changing Attitude toward Balanced Budget. Public expenditures, whether at the Federal, state, or local level, have been viewed as necessary outlays to defray the costs of various public services. A balanced governmental budget providing adequate revenue to meet necessary governmental expenditures has generally been considered evidence of sound public finance. On the other hand, an unbalanced budget has been viewed as an indication of fiscal mismanagement, which, if continued for any protracted period, would only lead to financial disaster and chaos.

This time-honored point of view has undergone a far-reaching modification in recent years. Proponents of the new attitude toward governmental fiscal policy maintain that public expenditures should not be incurred solely with an eye to a balanced budget, but, as previously indicated, should be extended to include maintenance of stable production and employment at all times.

14–17. Compensatory Fiscal Policy. The proponents of the so-called "compensatory fiscal policy" would seek to integrate the Federal budget with the total national budget, including public and private income and outgo. To realize this objective they would vary public expenditures from time to time with a view to stabilizing a high level of national income, and also vary the sources of funds used to finance the national budget to meet changing economic conditions.

Thus it is proposed that Federal fiscal policy should aim at either reducing taxes or expanding public expenditures of loan funds, or both, during periods of declining private business activity and deflation. Such a policy, it is held, would tend to maintain and even augment consumer demand during depressions and serve as a stimulus to revive private productive activity. On the other hand, governmental policy should seek either to increase taxes or to reduce expenditures, or both, during periods of business prosperity and inflation. Increasing taxes would serve as a brake on further business expansion, while decreased public expenditures would diminish government competition for relatively scarce productive resources during boom periods. The larger tax revenues would be employed to reduce public debts and thereby strengthen public credit, when needed in periods of depression. By these means it is hoped to maintain a constant and regular flow of income through the economy and offset, or at least mitigate, recurring periods of prosperity and business stagnation. "The stoppages in the circuit flow of income give rise to most of our economic troubles. The Federal budget is like the carburetor of an automobile. It may make the income flow a leaner or a richer mixture." [1]

In a general treatise on current economic problems it would carry us too far afield to consider the many controversial issues, both theoretical and

[1] WITHERS, WILLIAM, "Public Debt and Taxation in the Postwar World," p. 25, League for Industrial Democracy Pamphlet Series, N. Y., 1945.

practical, that have been raised by the new attitude toward the function of public expenditures and fiscal policy in general. But the achievements in production of our economy during the Second World War, under the stimulation of public expenditures, have led many to conclude that with properly planned governmental fiscal policies, integrated with private enterprise in our peacetime economy, it will likewise be possible to maintain steady employment and a high level of national income at all times. This point of view will be further developed in the next chapter, dealing with public borrowing for various purposes.

Guide Questions on Text

1. What is meant by public economy? How does it differ from private economy?
2. Define public finance. Distinguish between public and private expenditures.
3. Account for the continuous growth of public expenditures in our economy.
4. "Most important among causes of increased governmental expenditures have been outlays for war purposes." Explain and illustrate.
5. "Expenditures for national defense in times of peace cannot properly be included in costs of preparedness for war." Do you agree? Give reasons for your viewpoint.
6. Distinguish between the economic effects of public expenditures for direct relief, peacetime public works, and for war purposes, respectively.
7. What is meant by "socialization of consumption"?
8. Why have public expenditures for such consumption increased in our economy?
9. "Public-utility regulation has come to be recognized as an essential public service." Explain, giving illustrations of such regulation.
10. What criteria have been suggested to determine the "proper" scope of public expenditures?
11. Explain the meanings of "budget" and "budget control."
12. Criticize the customary attitude toward public expenditures.
13. Account for the changing attitude toward public expenditures since the depression of the thirties.
14. Criticize the proposal for a "compensatory fiscal policy."
15. "The stoppages in the circuit flow of income give rise to most of our economic troubles." Explain.

Topics for Investigation

1. Comparative analysis of costs of the First World War and the Second World War.
2. Economic effects of public expenditures for relief in a period of depression.
3. Social costs of the depression of the thirties.
4. Economic and social consequences of a "compensatory fiscal policy."
5. Functional analysis of public expenditures at the Federal, state, and local levels.

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CHAPTER XV

PUBLIC BORROWING AND THE NATIONAL DEBT

15–1. Sources of Public Receipts. Public receipts to defray the various public expenditures discussed in the preceding chapter come from many different sources. They may be obtained from public revenues, such as earnings of public enterprises, sale of public properties, fees, special assessments, and taxes; or they may be secured by public borrowing in one form or another.

All public revenues are public receipts, but not all public receipts are public revenues. Taxes are both public receipts and public revenues; loans are public receipts but not public revenues.

The nature and economic significance of public borrowing as a means of obtaining control over economic goods on the part of governmental agencies for their different needs will be discussed in this chapter. Public revenue derived from various sources will be analyzed in the following chapter.

15–2. Borrowing Not a Source of Public Revenue. The word "revenue" comes from the French *revenir*, meaning "to come back." It implies a return or reward for something, whether for commodities or for services. In this sense of the word, public loans cannot be construed to be "public revenue," for they are not a reward or return for public services. The final payment for such services, if made at all, no matter how long deferred it may be, is made by governments with taxes and public revenues from other sources enumerated above.

Loans, whether public or private, are liabilities of the borrower, while revenues are assets of the borrower. What a government borrows must ultimately be repaid, if at all, out of revenues. Therefore, when a governmental agency resorts to borrowing as a means of financing its present expenditures, the procedure is, in reality, equivalent to asking payments out of anticipated future revenues. A refunding operation merely substitutes one loan for another; it thus only defers the unpleasant process of raising additional revenues to repay the debts.

15–3. Purposes of Public Borrowing. Governments have made increasing use of their credit usually to obtain funds to defray nonrecurring, extraordinary expenditures. Such expenditures are frequently necessitated by unpreventable, or at least unpredictable, events. During the First World War and again in the Second World War, all belligerent coun-

tries resorted to borrowing, in one form or another, as a means of obtaining additional funds with which to pay for a part of their suddenly increased public disbursements.

Governments have resorted to borrowing for other reasons than to meet the increased expenditures resulting from a great national emergency such as war. Not infrequently they incur debts, the proceeds of which are employed to develop certain public enterprises, which, once developed, are expected to be self-supporting and eventually self-liquidating.

Funds required for the development of such projects are advanced to the government, primarily out of savings of investors in governmental obligations. The government thus incurs a liability that it hopes to repay, in whole or in part, with revenues derived from payments made for services rendered by the public enterprise. Municipal waterworks, Federal railways, public housing projects, and public hydroelectric plants, such as those of the Tennessee Valley Authority, are familiar illustrations.

Moreover, governments borrow to finance the erection of public buildings, such as schools, libraries, museums, and hospitals, investments that are usually non-self-supporting, and the construction of public works, such as roads, bridges, dams, viaducts, and the like, some of which may be at least partially self-supporting. Such durable public improvements yield their benefits to the community at large, either directly or indirectly, over a relatively long period of time. While the initial funds required for these projects are usually advanced to the government in the form of loans, they are ultimately paid for out of revenues derived from general taxes, and not from specific payments by the users of those public services.

15–4. Financing Economic Recovery by Borrowing. The new Democratic administration in 1933 was confronted with a budgetary deficit of 3 billion dollars growing out of the demands already made on the public treasury to relieve the distress of the depression. In its endeavor to stimulate recovery, to aid reemployment, and to raise the price level, the Federal government launched a program of public expenditures vastly in excess of current tax revenues. Since it had adopted a policy of price lifting, rapidly increasing public expenditures could scarcely be financed by increasing taxes. To do so might have had a deflationary effect on prices, by diverting an increased portion of an already diminished income stream into the public treasury. Consequently Federal debts were expanded to acquire large sums quickly and "painlessly." Such spending of loan funds by governments in periods of depression, it has been contended, will tend to stimulate recovery, and is popularly referred to as "pump priming."

a. Public Works Projects. Governmental pump priming is based on the theory that depressions are due primarily to an interruption in the circuit flow of money incomes. By injecting new or idle funds into the income stream through governmental "deficit financing," it is believed that

employment will be increased, production expanded, and business stimulated. But the effectiveness of such pump priming depends on the willingness of business also to expand investment in the face of the new monetary demand induced by government deficit spending.

The traditional fear of the inflationary consequences of an unbalanced governmental budget militated against substantial business recovery during the thirties, in spite of governmental pump priming. It will continue to be a partisan question as to whether or not recovery from the depression of the thirties would have followed the historic pattern of the business cycle, if the government had not resorted to deficit financing. But we have had occasion to observe frequently in our analysis of postwar economic problems that there is a need for intermittent governmental deficit financing resulting in unbalanced governmental budgets, to counteract the traditional ups and downs of business and thus to regularize productive employment by supplementing private enterprise with public works.

b. Dual Budgets. Should the "new" economic thought be accepted as a guiding principle of governmental fiscal policy, it is doubtful that it will be necessary again to have recourse to the budgetary expedients of the thirties, when the Federal government adopted the questionable policy of forming two budgets—one for ordinary governmental expenditures, the other for extraordinary emergency expenditures. The ordinary budget was balanced in 1933–1934, for regular routine expenditures were covered by revenues. But the extraordinary budget was considered "balanced," so long as revenues from taxation and other sources were sufficient to meet interest and amortization charges on outstanding governmental debts.

As appropriate measures to counteract deflation and to stimulate recovery, it would have been economically sounder to recognize the need for decreased taxes and increased borrowing to finance public expenditures, rather than to devise a double budget. But in view of the traditional belief in a balanced budget as evidence of sound fiscal policy, political expediency at times resorts to devious means to realize desirable ends.

Considering both ordinary and emergency outlays, the Federal budget was not balanced from 1930 to 1947. The extraordinary emergency budgets of the thirties were financed largely by public borrowing, in consequence of which the Federal debt[1] increased significantly, even before the outbreak of the Second World War, in 1939. Gross Federal debt, which had begun to rise in 1931, amounted to almost 43 billion dollars in June, 1940, as compared with slightly over 16 billion dollars in 1930.

c. Trend in Public Debt before the Second World War. The rapid increase in gross Federal debt between June, 1930, and June, 1941, is shown in Table 9.

[1] Includes debts "guaranteed" by the Federal government.

TABLE 9. INCREASE IN FEDERAL DEBT, 1930–1941 *

Date	Gross debt	Increase over preceding year	Cumulative increase since 1930
June 30, 1930	$16,185,308,000		
June 30, 1931	16,801,485,000	$ 616,177,000	$ 616,177,000
June 30, 1932	19,487,010,000	2,685,525,000	3,301,602,000
June 30, 1933	22,538,673,000	3,051,663,000	6,353,265,000
June 30, 1934	27,053,086,000	4,514,413,000	10,867,618,000
June 30, 1935	28,701,167,000	1,648,081,000	12,515,759,000
June 30, 1936	33,545,385,000	4,844,218,000	17,359,977,000
June 30, 1937	36,427,091,000	1,881,706,000	19,239,683,000
June 30, 1938	37,167,487,000	1,740,396,000	20,980,079,000
June 30, 1939	40,445,417,000	3,277,930,000	24,258,009,000
June 30, 1940	42,971,044,000	2,525,627,000	26,783,636,000
June 30, 1941	48,978,919,000	6,007,875,000	32,793,611,000

* Compiled from *Statistical Abstract* of the United States, 1943, p. 283, and 1944–1945, p. 303.

d. Relief Expenditures: Public Works. The stimulating effect of injecting loan funds into the income stream in a period of underemployment depends, in part, on where and when public funds are injected. A distinction should therefore be drawn between the expenditure of loan funds for direct relief on the one hand and public disbursements for a program of productive public works on the other. The economic effects of such expenditures are not necessarily the same. The former expenditures do not add directly to the real-income stream of society, growing out of production. Nor can they be said to increase consumption materially. If those on relief were kept alive, clothed, and housed before Federal relief expenditures were made available, and subsequently lived at or near the subsistence level with the aid of governmental loan funds, it can scarcely be argued that Federal aid greatly augmented aggregate consumption. Hence, the stalled motor of production was not given much of a start by such action.

On the other hand, public expenditures of loan funds to finance the construction of useful public works, when idle productive resources are available, tend to stimulate new production activity and to increase employment. Such expenditures provide not merely for the primary expansion of employment in the public projects themselves, but also for secondary expansion of productive activity in all those branches of private enterprise that furnish materials and services for these public undertakings. Moreover, as the additional income, induced by the expenditure of loan funds, is again spent, it will tend to further stimulate production to replenish the stocks of goods consumed. The larger income stream induced by a program

of public works will accelerate the real demand for more goods. Public borrowing to finance a program of public works as a means of augmenting the national income should thus be distinguished carefully from a public program of spending loan funds to provide direct aid for the needy. The former tends to increase production, while the latter serves to redistribute the income already produced.

e. Timing Public Projects. A major difficulty in devising an effective program of public works is the proper timing of these projects. Public works should be expanded when private investment is contracting. The reverse is equally true. But having once embarked on an extensive public works program sufficiently large to stimulate recovery, it may be difficult, if not impossible, for the government to withdraw without causing another business recession. This argument, however, can scarcely be accepted as a valid objection to public works projects as a means of stimulating productive enterprise, so long as millions are involuntarily idle and private enterprise is unable to provide adequate employment for them. If, under such conditions, governments have to continue their productive activities with the aid of loan funds, even in fields that may compete with private enterprise, in order to maintain high levels of productive employment, this action hardly warrants the adverse criticism often made of it.

15-5. Public Borrowing to Finance Wars. *a. Fiscal Significance.* While public debts have been incurred in our peacetime economy to finance programs of public works, wartime borrowing by the Federal government has been an even stronger reason for the rapid growth in public debts. During the First World War the national debt expanded rapidly. From 1917, the year the United States entered the war, until 1919, the gross interest and non-interest-bearing debt of the Federal government increased from about 3 billion dollars to 25.5 billion dollars. Without making corrections for changes in the purchasing power of the dollar, the Federal debt thus increased almost ninefold from 1917 to 1919. But these figures pale into insignificance when compared with government borrowing to finance the Second World War (see Chart 9, page 295).

At the close of the Second World War in 1945, the gross Federal debt exceeded a quarter of a trillion dollars. This debt was ten times greater than the Federal debt at the end of the First World War and five times larger than the public debt before America's entry into the Second World War in 1941.

b. Inflationary Aspects. The economic consequences of governmental deficit financing to meet war expenditures differ significantly from those incidental to borrowing to stimulate economic recovery. War creates an abnormal demand for productive resources. Competition for scarce resources between the government and private enterprise would soon tend to force prices upward if loan funds continued to expand to finance war

goods production. Wartime price controls and rationing merely conceal the potential price inflation, which would become real if the increased money demand due to wartime credit expansion were allowed to compete for the relatively scarce supply of salable goods. Under wartime conditions, it is therefore sound economic policy for governments to derive maximum revenue from taxes and so minimize the need for increased borrowing. By so doing, the upward pressure on prices is diminished and public credit is strengthened, while swollen wartime money incomes are diverted into the public treasury.

The pay-as-you-go policy for war finance, however, cannot be applied as rigorously in a period of economic depression as it should be applied

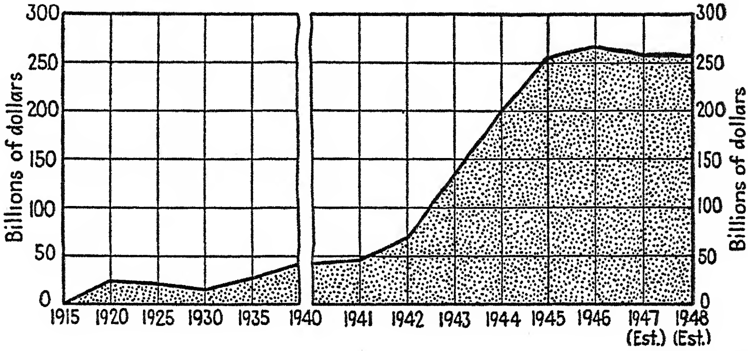

CHART 9. Effect of depression and world war on national debt. (*Courtesy of The New York Times.*)

during a war. During a depression there is little stimulus to production, prospects of profits are not bright, money incomes dwindle, prices decline, credit contracts, and industry is restricted. Under such circumstances, as previously shown, the depression would be accentuated and prolonged if governmental emergency expenditures were financed out of heavier taxes on declining current production and incomes. On the other hand, expansion of public works, as well as direct relief with the aid of idle or new loan funds, in a period of business depression, is warranted on the grounds that it will tend to increase monetary demand for the factors of production, as well as for salable consumption goods; with increased demand, opportunities for profitable employment of idle resources will be revived.

But while a depression is characterized by a deficiency of effective monetary demand to keep productive resources fully employed, expansion of loan funds during a war boom is apt to exert an abnormal upward pressure on prices. Not all governmental wartime borrowing, however, is necessarily inflationary. Whether it is inflationary or noninflationary will depend upon the sources of loan funds and the effect of their expenditure upon the physical volume of production. Inflationary borrowing tends to

increase the money flow more rapidly than the counter flow of salable goods. Noninflationary borrowing, on the other hand, results in no net increase in the money flow but merely diverts a part of the money income stream from private channels into public channels.

15–6. Sources of Loan Funds. The government may borrow from individuals, business concerns, investment institutions, public agencies, commercial banks, and Federal reserve banks. The economic effects of borrowing from these various sources upon wartime production and prices, as well as upon the ultimate size of the national debt growing out of the war, will differ significantly.

Loans may be viewed either as transfer credit or expansion credit. If made out of current or accumulated money incomes, they are in the nature of transfer credit, while loans of newly created funds are in the nature of expansion credit. Transfer credit, moreover, may be viewed as voluntary saving, while expansion credit, as will be shown later, may lead to forced saving, particularly when productive resources are fully employed.

a. Borrowing from Individuals. Individual investors in government bonds may purchase them with current savings of income, idle bank deposits, or hoarded cash. Such investments represent transfer credit.[1] The government gets the funds to spend, while the lender gives up his buying power by transferring it to the government. If the loans are made out of current incomes that would otherwise have been invested in private enterprise or spent for current consumption, the physical supply of money will not be increased. The money stream will merely be given a different direction. But the economic effects of such diversion of buying power from individuals to the government are significant, for goods demanded by the government for war purposes are not necessarily the same as those that would have been demanded by individual savers or private borrowers. Short-run prices of essential war materials will tend to rise, while prices of various civilian goods will tend to decline. In the absence of governmental selective price controls, windfall profits will accrue to owners of materials demanded by the government, while losses will be incurred by those whose market has been narrowed because of the diversion of buying power. But the general level of prices will not necessarily be forced upward by the extension of transfer credit to the government.

When individuals buy bonds with idle bank deposits or hoarded cash, they accelerate the money flow, and thereby stimulate new investment or consumption demand, depending on the use the government makes of the borrowed funds. But the funds thus released represent the value of goods already produced, and not new funds or expansion credit. The expenditure of these formerly idle funds by the government will, however,

[1] It is here assumed that the purchaser will buy with his savings and not borrow from commercial banks to make his investment in government bonds.

tend to increase the velocity of money circulation, and so exert an upward pressure on prices.

b. Borrowing from Business Concerns. When business concerns invest in government bonds, they may get the funds by liquidating inventory and not replacing it, or by skimping maintenance and replacement expenditures. In either case, private investment of funds will be displaced by government investment. But the total money flow will not necessarily be increased by such purchases of war bonds. On the other hand, business concerns, even as individuals, may buy bonds with idle bank deposits and thereby accelerate the velocity of money circulation.

c. Borrowing from Institutions. Private institutional investors, such as savings banks, trust companies, and insurance companies, ordinarily keep their excess funds invested. When they buy government bonds with their surpluses over current expenditures, which represent individual savings, they shift investments from private enterprise to public enterprise. This is a form of transfer credit. Whether it has also been expansion credit depends on the sources of the funds deposited by individuals with the investment institutions. The aggregate money flow will probably not be increased by such institutional investment in war bonds.

d. Borrowing from Government Agencies. Government agencies, such as the Social Security Board, may turn over their excess funds to the government by investing in war bonds. If they were to hold these funds as idle reserves, they would really be hoarding, which would normally have a deflationary effect on prices. Since the funds lent to the government come ordinarily from pay-roll taxes and other income deductions, the purchase of government bonds by public agencies does not put new money into circulation but merely changes the direction of the money flow.

e. Borrowing from Commercial Banks. The government may also borrow directly from commercial banks. If investment in government securities by the banks were offset by a corresponding repayment of bank loans, such lending would not increase the physical supply of funds, and would therefore be nonexpansionary in character. On the other hand, if banks increased their earning assets by purchasing government obligations, and sooner or later their deposits expanded as the government spent the loan funds, while the owners of the deposits preferred to hold them as ever larger cash or deposit balances, these loans would represent *expansion* credit, as distinct from *transfer* credit, as previously defined.

In this manner, new credit currency comes into being and, if not accompanied by a corresponding expansion of production, prices will tend to rise, even though they may be held in check for the time being by hoarding the newly created funds. Expansion of commercial bank credit to finance war expenditures became a major cause of concern during the Second World War because of its inflationary implications. In 1942 commer-

cial banks in the United States increased their holdings of government securities by over 20 billion dollars. During 1943, a further 18.5 billion dollars were added to the holdings of treasury bills, certificates, notes, and war bonds in the investment portfolios of commercial banks. Their total holdings of government securities were increased by another 18 billion dollars in 1944, and 6.5 billion dollars during the first half of 1945. At the close of the Second World War, nearly 84 billion dollars of the Federal debt was owed to commercial banks, exclusive of Federal reserve banks.

f. Borrowing from Federal Reserve Banks. Open-market purchases of government securities by Federal reserve banks are apt to be distinctly inflationary in character, particularly at a time when productive resources are more or less fully employed, as was the case in our economy during the latter part of 1941 and in the subsequent years of the Second World War. Further expansion of the supply of credit currency under such conditions does not induce a corresponding countervolume of production; it merely tends to raise prices. During 1942 Federal reserve banks increased their purchases of United States government securities in the open market by about 3.5 billion dollars. Under the 1942 Amendment to the Federal Reserve Act, moreover, they were permitted to buy up to 5 billion dollars of government obligations directly from the United States Treasury. At the close of the Second World War in August, 1945, holdings of government securities by Federal reserve banks totaled around 22 billion dollars.

The possibilities of government "borrowing" by expanding credit currency are practically without limit. Since governments exercise legal power over the issuance of currency, borrowing by governments could also take the form of issuing inconvertible paper currency. But the psychological effect of such currency expansion upon public confidence in the government's "promise to pay" has served as a deterrent to the outright issue of inconvertible currency. Instead, the Federal government has facilitated the expansion of bank credit currency to aid in war finance during the Second World War. As previously noted, in June, 1945, Congress authorized a reduction in the combined reserve requirements of Federal reserve banks from an average of 38 per cent against Federal reserve notes and deposits to 25 per cent, and made permanent the authority of Federal reserve banks to use United States government obligations as collateral against Federal reserve notes. This action of Congress further extended the possibilities of bank credit expansion to meet currency demands.

Federal reserve funds, released through purchase of government securities either from banks and bank customers or directly from the United States Treasury, tend to expand commercial bank deposits or "checkbook" money. This expansion, in turn, makes possible increasing member-

bank legal reserves, by depositing part of the funds entrusted to them with Federal reserve banks of their respective districts. Against these additional reserves they can extend further credit as needed, since commercial banks operate on a fractional reserve basis, *i.e.*, they are not required to hold a dollar in cash for every dollar of demand deposits.

Table 10 shows the distribution of the ownership of the Federal debt at the end of September, 1945, based on official Treasury estimates.

TABLE 10. OWNERSHIP OF THE GROSS FEDERAL DEBT *

Holders of Federal obligations	Amounts, billions of dollars	Per cent of total
Individuals	59.5	22.9
Corporations	28.9	11.1
Institutional investors	32.5	12.5
Governmental agencies (including state and local governments)	32.1	12.3
Commercial banks	83.7	32.2
Federal reserve banks	23.3	9.0
Total	260.0	100.0

* Compiled from U. S. *Treasury Bulletin*, Feb., 1946, p. 48.

g. Direct Compulsory Saving and Lending. The Federal government may also borrow by means of direct compulsory loans. Such compulsory saving and lending out of current money incomes, whether in the form of pay-roll deductions or otherwise, may have psychological advantages over taxation. It is not so likely to diminish individual incentive to increased output as would heavier taxes, since it holds out prospects of repayment at a later date. Although it adds to the public debt, it helps to transfer buying power from the people to the government, and so decreases the necessity, in part, of expansionary borrowing from banks for war finance. Direct compulsory saving out of current money incomes may thus be viewed as an effective wartime fiscal measure to aid in war finance and to curb inflation.

h. Diverse Sources of Fund. It should be borne in mind that the government is not limited to taxes and borrowing of current or accumulated money incomes from individuals, business concerns, and institutional investors as sources of funds to buy the goods when needed for the war effort. In addition to tax revenues and transfer credit, the government can get the needed funds from commercial banks and Federal reserve banks, if for one reason or another a sufficient volume of current money income and hoarded

funds cannot be diverted to the public treasury to provide the required buying power. But regardless of source, the funds are used by the government primarily to buy economic resources needed for war output.

15–7. Varying Effects of Governmental Wartime Borrowing. A study of the many implications of wartime governmental borrowing thus requires careful inquiry into the sources of the funds lent to the government. In general, if they represent transfer funds, their use by the government will be offset by their nonuse by the savers; transfer credit is noninflationary in character. On the other hand, if the funds are in the nature of expansion credit, or new currency, they tend to become inflationary, unless accompanied by an expansion of production. While there was a large margin of idle productive resources in our economy prior to 1941–1942, new money flow, induced largely by commercial-bank credit expansion, did not force the level of prices upward to any significant extent, for the physical volume of production also was expanding. From the middle of 1940 until the spring of 1941, total industrial production increased 25 per cent, durable goods production increased 43 per cent, but wholesale prices rose only 3 per cent, despite an expansion of bank credit.

This picture changed rapidly as full normal employment of our productive resources was reached in our war economy, while the demand for war output continued to expand. It was then, as previously noted, that expansion credit became a definite inflationary threat, for the money demand for salable commodities and services was increasing more rapidly than the supply of such goods. In the absence of price controls, such increased money demand for a limited supply of goods would have caused prices to rise all along the line.

15–8. Compulsory Thrift through Inflationary Borrowing. Expansionary or inflationary borrowing from commercial banks and Federal reserve banks by the government is, in reality, a subtle form of compulsory thrift or concealed taxation. It diverts economic resources from individual owners to the government for "collective consumption" in the war effort. A simple hypothetical illustration will make this clear.

Assume Mr. X has been earning a wage or salary of $3,000 a year, which measures the value of his contribution to the national income. He spends $2,400 annually for current consumption and saves $600. If the level of prices were to rise because of inflationary borrowing by the government, so that for the same quantity of civilian goods he had to pay $3,000 for which formerly he paid $2,400, while his money income did not increase, he would not be able to save any money unless he were to lower his level of current consumption. If he produced as much as he did before prices advanced, he would now be consuming four-fifths of the value of his output even as he did formerly. The remaining one-fifth of his production would have been "saved," but neither voluntarily by him nor specifically

for him. Nor would it necessarily be "saved" by the economy as a whole, if it were consumed currently for war purposes. It would, however, have been taken from his income, and from others in the same position, through price inflation induced by expansionary borrowing. The government would have secured possession of goods for use in the war effort, even as it might have obtained them either by taxes or by direct loans.

Moreover, if Mr. X (symbolic of millions of war workers) were transferred from civilian goods production to work in war industry at $3,000 annually and were paid with expansion funds by the government, the money demand for civilian goods would be increased, while at the same time civilian goods output would tend to decline, unless existing resources could be made to produce more efficiently or unused resources be put to work. Prices would tend to rise, and sooner or later Mr. X and others would discover that it required all of their money incomes to maintain their usual living standards.

If, in the face of such conditions, still more of the national output were needed for the war effort, it would have to be obtained by encroachment on former living standards, unless perhaps foreign investments could be liquidated and net imports be expanded. But this latter possibility would add relatively little to meet the abnormal wartime demands on our economy. More would therefore have to be saved domestically and less consumed by our civilian population. Such restriction on consumption could be achieved by further taxation, voluntary reduction in consumption, and increased investment in war bonds, as well as by compulsory saving and investing.

While compulsory saving in the form of pay-roll deductions or withholding levies on incomes at their source is noninflationary, compulsory saving by means of currency expansion, whether in the form of printing press money or bank credit, is inflationary borrowing, which adds to the money costs of the war as prices continue to rise. Moreover, inflation is a very inequitable form of compulsory saving, since it hits particularly those whose money incomes are relatively fixed, while all those whose incomes may be adjusted upward from time to time, to allow for changes in living costs with rising prices, will not be making their proportionate share of the real sacrifice required to wage total war effectively. The need for wartime price controls and rationing, under such circumstances, becomes apparent.

15–9. Illusion of Shifting War Burdens to Future Generations. Many conflicting views are held as to the expediency and economy of public borrowing instead of taxing to finance war. It can be argued that the possibility of shifting a part of the physical burden of war to future generations by domestic borrowing is illusory and illogical. The war is fought with present goods and man power. The losses of such goods and man

power, due to the destructiveness of war, are borne by the generation that fights the war and not by future generations. Those who sacrifice what they possessed in either material wealth or labor power are the real losers. Future generations, it is contended, never possessed what was destroyed during the war, and no one can lose something he has never had.

This line of reasoning may be illustrated by a very simple example. Assume that the average citizen, A, loaned his government $1,000 during the Second World War, in return for which he received a claim on the government in the form of a bond for $1,000, payable, say, in 25 years. How will the government obtain the necessary revenues, assuming that the loan was floated within the country and that no indemnities were exacted with which to repay the loan? Such revenues will in all probability be derived from taxes. If now A, because of the governmental obligation to him, finds that he is required to pay in Federal taxes every year an amount equal to the interest he is receiving on his bond, plus the costs of either sending to him his semiannual interest check or paying his coupons and collecting the interest from him in taxes, in addition to an amount that, at the end of 25 years, will be the equivalent of $1,000, which will then be repaid to him, he may well ask himself what has become of the original $1,000 that he loaned to the government.

He has, in reality, given the government $2,000, plus the interest he has received on his loan, in addition to the costs of administering the debt. He (or his heirs) ultimately receives $1,000 from the government in payment of his bond. If the government had not been obligated to repay the $1,000 borrowed during war, A would not, under the assumed conditions, have been obliged to pay the taxes required to redeem the governmental obligation at maturity. He could have saved the amount he had to pay in taxes, and at the end of 25 years would presumably have accumulated another $1,000. Thus, the original $1,000, which he loaned to the government during the war, is lost, as far as A is concerned. He might just as well have paid it in taxes directly to the government, and thus have saved himself and others similarly situated the costs of collecting revenues and administering public debts.

Even though we may accept the validity of this argument, we should not lose sight of the possible postwar frictions in our economy arising from the existence of our huge national debt. Before considering the implication of the Federal debt to our postwar economy, let us note the reasons why governments borrow, rather than merely tax, to finance war expenditures. It is sufficiently clear that the purpose of both borrowing and taxing is identical. Either method is employed to transfer immediate control over commodities and services from private ownership to the government. There are, however, certain advantages of borrowing over taxing for war finance.

15–10. Advantages of Borrowing for War Financing. Borrowing for war financing gives the government immediate control of monetary purchasing power, whereas taxing involves time in legislating and collecting taxes. Second, borrowing will frequently bring forth accumulated savings that might not be attached by specific taxes. Third, borrowing makes possible the social appeal that in times of a national emergency, such as war, is often a more potent factor in achieving results than is legal compulsion. Fourth, borrowing generally leaves the time and manner of making payments to the discretion of individual lenders. Fifth, borrowing, rather than taxing, holds promise of repayment; thus it may not have such a retarding effect on production. Sixth, there are some individuals who will sacrifice in times of war to aid their government financially; they will curtail their consumption, even of so-called "necessities," to buy bonds "till it hurts." It is doubtful whether any system of heavy taxation hastily devised under wartime conditions would meet with public approval. It is a well-established observation that human beings make sacrifices voluntarily against which they would rebel if made under legal compulsion. Finally, inflationary wartime borrowing makes possible the acquisition of resources by the government by a form of concealed expropriation, which seemingly is more acceptable to the public than heavier direct taxes. But these apparent advantages of borrowing rather than taxing to finance wars should not cause us to lose sight of some of the dangers to our postwar economy arising out of the existence of a large internal war debt.

15–11. Postwar Implications of Our Large Public Debt. Contrary to popular belief, our postwar economy is poorer and not richer as a result of the war boom, not only because much of the wartime capital formation was unsuited for peacetime production, but also because some of the existing capital was allowed to deteriorate, due to inadequate wartime maintenance, improvement, and replacement. Moreover, much of the wartime individual saving was consumed in prosecuting the war. Nor should we overlook the loss in human and material resources incidental to waging total war. Public-debt service charges represent claims against the income of a partly impoverished economic system. These claims are not related to any increased economic productivity resulting from normal remunerative investment of savings. They must be met by levying against incomes, which, however, have not been produced by investment in the war effort.

Debt service payments thus mean a postwar redistribution of income, not related to the productivity of capital, but according to the ownership of commercially unproductive investments. The owners of bonds have claims against the national income, which have to be paid by taking it from those who have produced it and giving it to those who own the bonds. If the bondholders were also the producers of the income taxed away by

the government to meet debt service charges, in direct proportion to which they owned bonds, there would be no significant income redistribution resulting from such interest payments.

a. Optimistic View on Large Public Debt. There are two schools of thought as to the long-run significance of annual debt service charges of possibly 5 billion dollars or more on our national debt, which exceeded 275 billion dollars by the end of the Second World War, in 1945. One school holds that so long as the Federal debt is an internal obligation, it is in essence owed by the people to the people. As previously indicated, if requirements for interest were met each year out of taxes collected from bondholders in direct proportion to which they own government bonds, and the interest rate were uniform, this would obviously not affect the redistribution of the national income directly, aside from possible payment of debt-administration costs. It would be analogous to robbing Peter to pay Peter. If such a tax program were conceivable, it would serve to demonstrate the illusory nature of borrowing, rather than outright taxation, as an alleged method of shifting the real cost of the war onto the future. But the bondholders, under such conditions, would then not be bearing their proportionate and equitable share of the peacetime costs of the services of government.

With efficient management, the public debt need cause no concern. The public debt is not like a private debt. The taxes raised to pay interest charges are not thrown into the ocean. They are paid right back in the form of interest receipts by the bondholders. Two-thirds or more of the bonds are held by socially useful institutions, the social security trust funds, savings institutions, educational and charitable institutions, life insurance companies, and commercial banks. A large part after the war will be held widely by the community so that considering the distribution of the bonds on the one side and the distribution of taxes on the other the net effect of the large public debt will not be adverse to an equitable income distribution.

A widely distributed holding of government bonds after the war will be itself a factor guaranteeing security for the mass of the population. This is true since in depression years we can expect holders of bonds to cash them in order to sustain their necessary consumption.[1]

b. Pessimistic View on Public Debt. It is doubtful whether this optimistic interpretation of the implications of our postwar national debt will meet with general acceptance. Since as a matter of practical reality, taxpayers and bondholders are not necessarily identical, and because of the commercially unproductive nature of a large part of the wartime "investments," there is also a school of thought which views the possible postwar frictions that may grow out of our large national debt with considerable apprehension.

[1] Hansen, Alvin, *News Letter on Economic Problems*, Feb., 1943.

If postwar normal Federal expenditures, financed out of taxes, were to amount to upward of 15 billion dollars annually, while another 5 billion dollars had to be collected to pay interest on the public debt, the average Federal tax load borne by taxpayers would be increased 33 per cent because of these debt service charges. Even in peacetime, such Federal taxes might not prove excessive and unduly burdensome so long as the national income remained around 150 billion dollars at 1945 prices, but they would tend to become prohibitive in case of a major postwar depression and a substantial decline in the national income. The existence of the large national debt may thus be viewed as an important consideration in shaping Federal fiscal and economic policies designed to maintain a high stable level of national income, stable employment, and a relatively high price level.

Servicing a debt of upward of 250 billion dollars may restrict postwar government freedom of action in developing necessary public projects designed to aid in maintaining high levels of peacetime employment. If 30 per cent or more of annual Federal tax revenues is currently absorbed by debt service charges, it may become increasingly difficult to obtain popular approval of continued debt expansion to finance public works, particularly in periods of major depression.

Nor should we overlook the psychological reactions of taxpayers to the huge national debt. Taxpayers ordinarily do not relate tax payments to returns on investments, irrespective of whether these investments represent public or private obligations. To the average taxpayer all taxes appear burdensome, and resistances of pressure groups may create decided inequities between taxpayers and bondholders.

Again, the incidence [1] of postwar taxes to service the national debt must be carefully considered. If, in the long run, too heavy taxes were to be levied on current incomes, normally spent for civilian consumption, to meet debt service charges, the resultant decreased demand for consumers' goods might seriously affect the profitability of various business concerns. If these concerns were also large government bondholders, receiving interest payments from the government, their investment returns might be maintained at the expense of their profits, because of the taxes imposed on consumer demand. In other words, what they and those similarly situated might be getting in interest on government bonds, they might, in turn, be losing in normal business profits. Under such circumstances, taxes to meet the debt service charges would tend to fall, in part, on the creditors of the government.

The nature of the tax program adopted by the government to service our huge national debt thus becomes an important factor in giving shape to

[1] By incidence of a tax is meant the final resting place of a tax, or the person on whom it ultimately falls. See page 321.

our postwar economy. The complexity of the many interrelated considerations involved makes predictions impossible but offers a fruitful field for speculative inquiry. Tax frictions, an important postwar issue, tend to be accentuated by the increasing need for public revenue not only to meet the expanding functions of government but also to pay heavy debt service charges incidental to carrying our large national debt.

15-12. Debt Repayment and Long-term Interest Rates. The traditional policy of the Federal government has been to repay national debts growing out of war as speedily as possible. In 1836 the United States had practically no national debt, in spite of the public debts arising out of the Revolutionary War and the War of 1812. Again, the national debt, which at the close of the Civil War amounted to 2,845 million dollars, was reduced to 839 million dollars by 1893. Moreover, the public debt growing out of the First World War, which totaled nearly 27 billion dollars in 1919, had been reduced to 16 billion dollars by the end of 1930.

The magnitude of the public debt arising out of the Second World War precludes the likelihood of its rapid reduction and eventual elimination. The debt may be wiped out, in part, through price inflation after the war, but this would not be debt repayment; it would be partial repudiation by cheapening the dollar.

It has been facetiously remarked that the national debt will probably be repaid by never being paid. This paradoxical remark should not be interpreted to mean that the Federal government will either wipe out the debt by recourse to hyperinflation or default in meeting its contractual dollar obligations. It means rather that over a period of years, as one bond issue matures, it will be refunded with a new marketable issue. Eventually most of the outstanding bonds may be converted into perpetual annuities, even as some of the British consols, originating in 1753, are perpetual annuities.

While some persons may want to spend the cash value of their government bonds either for current consumption or for alternative investments, others seeking safe dollar investments for their savings may purchase those bonds in the open market. The price at which such bonds would sell would depend on the postwar trend in long-term interest rates. A possible rise in interest rates would tend to lower the market value of relatively low-interest-bearing government bonds, and, if sufficiently extended, might seriously impair public credit. To prevent such a possible decline in government bond prices, public policy would, in all probability, be designed to counteract any pronounced upward trend in interest rates. Hence the easy-money policy that was pursued by the Federal government even before the Second World War is apt to be extended into the postwar period.

If, however, the bondholding public should prefer to hold its marketable "debt" assets in the form of "real" assets or actual goods on a large

scale, any such shifting of assets would either depress bond prices and thus increase bond yields or, if Federal reserve banks continued to support the bond market, would result in inflationary expansion of bank funds. In either case, bondholders would be subjected to severe loss. Such loss can be minimized by averting a wholesale liquidation of the public debt, and by spending the accumulated wartime savings conservatively and gradually.

With expansion of peacetime production and increased productive efficiency it should be possible for our economy gradually to absorb the accumulated wartime monetary purchasing power in the hands of the public without an excessive rise in the price level. But the immediate threat of inflation will continue to be very real until the major portion of the public debt has been moved from the asset portfolios of commercial banks into the investment portfolios of individuals and institutions through appropriate debt refunding. The interest yield on long-term marketable government obligations will be a major factor in controlling the inflation potential inherent in the existence of our large Federal debt.

Several proposals have been advanced to convert an increasing portion of the Federal debt into various nonmarketable securities, with special privileges attached, such as life and beneficiary annuities or stable purchasing power provisions with sliding interest rates adjusted for changes in the cost of living. The possibility of integrating the wide ownership of the public debt with an expanded program of social security also has been suggested. All such proposals would seek to give some degree of assurance to the holders of Federal government obligations that their wartime savings will retain an element of real value for years to come if judiciously employed.

15-13. Increases in State and Local Governmental Borrowing. While the size of the Federal debt overshadows the debts of state and local governments, public borrowing by these units of government likewise expanded considerably, particularly during the interwar period; and it promises to expand further in postwar years. The combined net debts of state and local governments almost doubled, from about 8.7 billion dollars in 1922 to around 15 billion dollars in 1944. Nevertheless, in relation to the Federal debt of over a quarter of a trillion dollars, these debts of the lower units of government are relatively insignificant. But in view of the limited tax resources of local governments, which owe nearly 85 per cent of total state and local-government indebtedness, the proper management of these debts becomes an economic problem of decided importance.

Whereas a large part of the Federal debt may be periodically refunded, and may eventually become a perpetual annuity, state and local governments should not be encouraged to carry their indebtedness indefinitely; they should make every effort to amortize their capital outlays over the

estimated useful life of the capital assets constructed with the aid of loan funds. To avoid future embarrassment, capital outlays, financed with the aid of loan funds, should be held in check by setting definite legal limits on the right to incur public debts, particularly by local governments. Their limited sources of tax revenues suggest the need for such conservatism in incurring public debts.

Again, state and local borrowing to finance various public projects should be made to dovetail, as far as possible, with the phases of major business cycles, expanding as private investment of savings declines and contracting as private investment expands. It would thus become a stabilizing factor in our economy. Although of minor importance, it would aid in maximizing social benefits and minimizing costs of public improvements, financed with loan funds. To attain these objectives, as previously indicated, a reserve shelf of useful public projects should be carefully prepared by governmental planning bodies. Appropriate steps should be taken in advance by responsible governmental agencies to make those plans effective at the proper time without unnecessary delays. If such broad directives were made the guideposts for postwar capital development with the aid of loan funds on the part of state and local governments, they would tend to minimize the burden of debt service charges on governmental budgets and help to achieve a higher degree of economic stability in our postwar economy than existed in prewar years.

Guide Questions on Text

1. "All public revenues are public receipts, but not all public receipts are public revenues." Explain.
2. Why is public borrowing not a source of public revenue?
3. Why do governments borrow rather than tax to help defray public expenditures?
4. What is the theory behind governmental "pump priming" in a period of depression?
5. Account for the traditional fear of the inflationary consequences of an unbalanced governmental budget. Do you think this fear is warranted? Why or why not?
6. "Any stimulating effect of injecting loan funds into the income stream in a period of underemployment depends on where the funds are injected." Explain and illustrate.
7. Point out the significant differences between public borrowing for war financing and to provide public assistance in a period of business depression.
8. Distinguish between inflationary and noninflationary governmental borrowing for war financing.
9. Trace the various sources of loan funds available to the Federal government for war financing, and indicate clearly which of these sources may be inflationary, and which noninflationary.
10. "Inflationary borrowing is a sinister form of compulsory saving." Explain and illustrate.
11. "When governments borrow rather than tax to finance the cost of a war, the burden of the war is shifted to future generations." Criticize.

12. Point out the advantages and disadvantages of borrowing over taxing to finance wars.

13. "Our postwar economy is poorer and not richer as a result of the war boom." Do you agree? Reasons.

14. Point out some of the implications of the existence of our large national debt.

15. "It has been facetiously remarked that the national debt will probably be paid by never being paid." Does this mean that the debt may be repudiated by the Federal government? Explain.

16. "The easy-money policy pursued by the Federal government before the war will very likely be continued in the postwar period." Why?

17. How may state and local governmental borrowing to finance public projects be made a stabilizing factor in our economy?

Topics for Investigation

1. The structure of the Federal debt.
2. Implications of commercial-bank holdings of government obligations.
3. The inflation potential in the Federal debt.
4. Fiscal policy and the public debt.
5. The debt burden and the business cycle.
6. Incidence of debt service charges.
7. Alternative policies of public-debt management.
8. Sources of loan funds to finance the Second World War.

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CHAPTER XVI

PUBLIC REVENUES

16–1. Nature of Public Revenues. *a. Items Included.* Public revenues may be defined as those governmental receipts that result in an increase in the aggregate assets of a government without causing an equal or greater increase in its liabilities. They include receipts from all kinds of taxes, fees, special assessments, fines, forfeits, escheats, highway privileges, interest, rents, donations, gifts, earnings of governmental departments, and earnings of public-service enterprises.

b. Items Excluded. Public revenues do not include proceeds from the sale of public property nor repayments of public investments. These transactions represent a conversion of assets from one form to another without increase in their value. Nor do public revenues include specific receipts to offset specific outlays, such as collection of insurance to be applied to the reconstruction of destroyed property. Again, they do not include refunds of erroneous payments and receipts in error, such as taxes paid by mistake or under protest, which are subsequently refunded. When a government receives taxes under protest, a contingent liability is at once incurred to offset this particular asset. Only when the government's claim to such receipts is sustained by the courts do they become public revenues. Otherwise they have to be returned to the taxpayers, as were the processing taxes paid under protest, when the Agricultural Adjustment Act was declared unconstitutional in 1936. Furthermore, as was noted in the preceding chapter, public revenues do not include receipts from loans to a government unit. A sovereign government can always acquire sufficient receipts to meet its expenditures, even though it may experience considerable difficulty in finding adequate resources to balance its budget.

16–2. Classification of Public Revenues. A commonly accepted classification of public revenues divides them into gratuitous, contractual, and compulsory contributions.[1] Gratuitous contributions, as the term implies, are voluntary, public or private, gifts, donations, or bequests made to a governmental agency, usually for a specifically designated purpose. Contractual revenues are those public receipts derived from various forms of

[1] SELIGMAN, E. R. A., "Essays in Taxation," 9th ed., pp. 399*ff*, The Macmillan Company, New York, 1921.

public property and from public-service enterprises. They represent specific prices established either by mutual bargaining or by exercising monopoly control, paid by individuals for specific services rendered or for commodities received. They are sometimes referred to as "rates," in contrast to gifts and taxes. Compulsory contributions are those payments exacted by public authority by virtue of the "power of eminent domain, of the penal power, or of taxing power."[1] They include expropriations, fines and penalties, fees, special assessments, and taxes.

Omitting gratuitous contributions, which are relatively unimportant as sources of revenue of modern governments, the above classification of contractual and compulsory contributions may, in turn, be analyzed as to purpose. In contractual payments, special benefits are the primary consideration and public welfare is incidental, whereas in the case of taxes, special benefits are incidental and general welfare is primary. Between prices paid for specific services and taxes collected for public purposes, other governmental contributions shade more or less imperceptibly from voluntary to compulsory payments.

16–3. Development of Public Revenues. Chapter XIV traced the growth of public expenditures with the increasing complexity of our economic, social, and political institutions. As these expenditures increased, old ideas as to methods of raising public revenues were modified by the gradual introduction of new principles.

Public funds to meet public expenditures were derived in ancient times from voluntary gifts bestowed by individuals upon their governments. When such voluntary contributions no longer sufficed to defray their continually increasing expenditures, governments not infrequently besought the people for additional financial support. During the Middle Ages kings and princes obtained considerable revenues from public domains that were let to their subjects in return for a share of the product yielded by such lands. With the development of private ownership of land, the custom slowly grew up of transferring title to the occupants on condition that they pay in perpetuity an annual ground rent to their former possessors and noble heirs.

Even such contractual contributions did not suffice to meet the increasing public expenditures, particularly those of the past century and a half. The idea of sacrifice on the part of individuals in the interest of their government gradually gained in importance. Specific benefits to individuals derived from their contributions to the public coffers became less and less significant. Feeling themselves integral parts of the complex social organism, and realizing the increasing public benefits resulting from ever-extending governmental activities, citizens of advanced countries gradually developed a sense of public obligation and social responsibility, which

[1] *Ibid.*, p. 430.

caused them to submit to the compulsory levy of direct taxes in one form or another.

Recognition of the justice of such taxes is rather modern. Even today many citizens do not fully assume this civic duty; instead they employ both their own cunning and the shrewdness of others to evade as much as possible their tax obligations. Not until this high sense of civic duty is fully developed do citizens willingly submit to various kinds of indirect and direct taxes for the general welfare instead of for their own specific benefit.

16–4. Gratuitous Contributions. Donations and gifts, which formed the chief source of public revenues in primitive society, have today become relatively unimportant. Of the aggregate total revenues of the national, state, and local governments in the United States in 1913, gifts and donations were less than one-fifth of 1 per cent, amounting to only 5.7 million dollars. Benevolent individuals occasionally have seen fit to bestow gifts, in the form of libraries, museums, art collections, public parks, playgrounds, and the like, upon municipalities and states for the benefit of the general public. Such gifts, however, are usually designated for a specific purpose by their donors and cannot be employed to meet general governmental obligations. The economic depression after 1929, for example, elicited many voluntary contributions to state and local unemployment-relief organizations; the amount thus contributed in six cities, New York, Chicago, Washington, Philadelphia, Baltimore, and Boston, was estimated at 142.5 million dollars in 1933.

The progressive rates of the Federal estate tax and state inheritance taxes will probably continue to induce individuals of means to perpetuate their memories by liberal gifts for specific purposes before death, rather than to permit a large portion of their accumulated wealth to flow into the general public coffers after their decease. In so far as the individual benefactor has provided the community with a source of greater durable benefits than would have resulted if the funds had been expended by public authority, the community has gained. Any such act cannot be judged solely from the standpoint of the motive of the donor, but must be viewed also with reference to public benefit.

16–5. Grants-in-aid. One governmental unit may make gifts of public funds or grants-in-aid to another, particularly in times of a great national emergency. Grants thus made are usually for a specific purpose, to be apportioned by the recipient government or its representatives according to recognized needs. This was illustrated from 1933 to 1935 by the large Federal appropriations for direct relief to the various states of the Union. The Federal Emergency Relief Act of 1933 directed the Reconstruction Finance Corporation to make 500 million dollars available to the Federal Emergency Relief Administrator. This was in the nature of an outright grant, not subject to repayment.

In 1941 Federal grants-in-aid for specific purposes, including education, public assistance, highways, health and hospitals, and employment security, totaled 744 million dollars. On the other hand, state grants-in-aid to local governments aggregated almost 1.7 billion dollars in the same year. Of this total only 11.4 per cent was for unspecified purposes.

The trend of grants-in-aid to one unit of government by a higher governmental unit was distinctly upward prior to the Second World War. Moreover, for many years both Federal and state governments have been extending increasing aid to finance government functions of a more local nature, which, in turn, has given larger units of government increasing ability to influence expenditures of small units of government. What this trend will mean—if continued in the postwar period—to local self-government on the one hand, and to the concentration of governmental control in larger units of government on the other hand, is not difficult to foresee. But it reflects the general tendency in modern industrial societies toward growing concentration of governmental power in the higher units of government.

Public gifts may take another form. At some time in the past, one sovereign government may have borrowed extensively from another to meet certain extraordinary expenditures. If the creditor government subsequently relieves the debtor, either in whole or in part, of the financial obligations thus incurred, it has, to that extent, made a gift to the debtor nation. If, for example, the United States were finally to cancel the obligations of foreign countries arising out of the First World War, this action would be analogous to making a public gift to these debtor countries. Actually this gift, in any real sense, was made long ago, and removal of the "claim" from the books of the Federal government would merely make formal record of an accomplished fact. As previously pointed out, shortly after the conclusion of the Second World War, some 25 billion dollars of lend-lease obligations of the United Kingdom to the government of the United States were written off or canceled. This action also may be viewed as making a public gift, even though it may not be so regarded in Great Britain.

The reasons for all such "magnanimous" acts, however, require careful analysis, for it may be contended that the seeming gratuities were prompted by other than altruistic motives. Methods of making international payments and their possible adverse effects upon industries in creditor countries should be reviewed in this connection. They may represent weighty factors in inducing creditor nations to forgive these war obligations.

16–6. Contractual Contributions from Industrial Sources. Public revenue from industrial sources, in the broadest sense of the word, includes rents and interest received on public properties and investments as well as the earnings derived from the sale of the product of public-service enter-

prises. In the Middle Ages the private domains of kings and nobles provided the chief source of public revenue, which in many medieval states sufficed to meet most public expenditures. Subsequently, however, these revenues decreased, as governments gradually relinquished publicly owned wealth to private individuals and adopted a laissez-faire policy toward industry in general.

During the past 50 years governmental policy toward "public-service enterprises" has been undergoing a gradual change. Many public-service enterprises, such as those supplying transportation, light, power, gas, and water, have been undertaken by local governments in the United States. In 1932 the earnings of state and local public-service enterprises amounted to 530 million dollars, or approximately 6 per cent of the total revenue. In postwar years, the absolute amount of earnings of state and local public-service enterprises may increase further, as self-supporting public projects are developed by local governments; but as a percentage of total revenue receipts this item may show an actual decrease. Increased public operation of public-service enterprises, as will be shown in Chap. XXIV, has been more pronounced in European countries than in the United States. The general impression has prevailed in this country, at least until recently, that private operation of public utilities under governmental supervision is to be preferred to public ownership and operation.

In 1914, the Federal government initiated the policy of leasing certain public lands to private enterprisers for the purpose of developing their mineral resources. This principle was further extended in 1920 to include oil and gas lands in Alaska, as well as in continental United States. As yet, the Federal revenues derived from public leaseholds are relatively unimportant.

It will be shown in Part Seven that governmental regulation of natural monopolies of organization has increased greatly during the past 20 or 30 years. If this supervision should fail or prove ineffective, there appears to be but one logical sequel, namely, actual governmental ownership and operation. It is generally conceded that unrestricted private operation of public-service enterprises has been undesirable from the standpoint of the community. The production and sale of electric current by the Tennessee Valley Authority, created in 1933, may yet become a yardstick for measuring the relative efficiency of public and private utilities. But in order to make any valid comparisons, it is necessary to give careful consideration to all the elements of cost involved in the production and sale of electric power. Aside from postal receipts, Federal revenues derived from earnings of public-service enterprises have been relatively unimportant to date.

16–7. Compulsory Contributions. *a. Fees.* Public fees are not specific prices for services accruing primarily to the benefit of the individual. They are rather compulsory or semicompulsory payments exacted by the

government for specific services rendered in the interest of the public, but conferring some benefit upon the individual making the payment. They are, however, not necessarily proportionate to the individual benefits conferred. Illustrations of such fees are automobile licenses and fees for recording legal documents.

It is the boast of many governmental departments that they cost the public nothing, since the fees collected for specific services that they render more than pay for their total costs. The validity of such an assertion may be questioned. In the final analysis, fees resemble taxes levied in accordance with the "specific-benefit" principle, rather than in accordance with the general "faculty" principle of taxation, to be discussed later.

The primary reason for charging public fees is to regulate the activities of individuals in the interest of the community. In general, it has been found that an individual is willing to pay a fee for the privilege of carrying on a particular activity. Wherever the value of such a privilege to the individual can be estimated approximately, it is charged to him rather than paid for out of the general revenue fund. The Federal government derives revenues in the form of fees from the issue of passports, letters patent, consular services, and the like, while states and municipalities obtain fees for many kinds of licenses and permits, such as hunting and fishing licenses, building permits, operators' licenses, and the like.

b. Special Assessments. Special assessments are compulsory payments made to a public authority by an individual in order to defray the costs of improvements accruing to the benefit of the general public, but paid for by the property owner in proportion to the appraised value of his real estate. Illustrations are assessments for sidewalk construction and sewer connections.

Special assessments are justified by the benefit an individual is supposed to derive from such improvements to his property. They should not be confused with special taxes that are levied for a particular social purpose, such as poor relief or school maintenance.

Assessments differ from fees in that they are usually nonrecurrent payments levied against property rather than against the person benefited.

c. Taxes. The combined revenue receipts of all governmental units in the United States from the different sources enumerated above form but a minor portion of the aggregate total revenue receipts. The major portion is derived from either direct or indirect taxes.

A tax may be defined as a compulsory contribution exacted for public purposes by a governmental agency according to some general rule, without conferring a special benefit upon the payer. An analysis of this definition will indicate the difference between a tax and a fee, on the one hand, and between a tax and a special assessment, on the other. In the first place, a tax is a compulsory payment and, in the second place, no specific

benefit accrues to the taxpayer. As noted above, a tax presupposes a highly developed sense of social ethics and civic obligation on the part of those who submit to such a compulsory levy by a governmental agency without special or proportionate benefit to the taxpayers.

16–8. Kinds of Taxes. Taxes are either direct or indirect. An indirect tax is one that is collected either from the manufacturer or the importer of an article, but that is intended to be shifted to the ultimate consumer by adding approximately the amount of the tax to the selling price of the article taxed. The ultimate buyer generally pays the tax without being conscious of its imposition. But the tax may also be shifted backward, in part, by paying lower prices for the factors of production, because of decreased demand for the items taxed.

A direct tax, on the other hand, is one that is levied against individual property or income; it is intended to be collected from those who possess the property or receive the income. The individual is conscious of the fact that he is paying the tax. Unless the taxpayer recognizes his civic obligation, he is likely to resort to all possible means of evading the obligation or shifting it to someone else.

Direct taxes, in the form of property and income taxes, have grown considerably in relative importance to indirect taxes in the United States during the past century. In 1791, the Federal government of the United States derived all of its revenue to meet the total expenditures chargeable against ordinary revenues from indirect taxes in the form of customs duties. Not until 1863 did it obtain any revenues from direct taxes. During the Civil War and post–Civil War periods, direct taxes still constituted but a minor source of public-revenue receipts. On the other hand, between 1919 and 1932, Federal income and profits taxes were the chief sources of tax revenue. But with the decided shrinkage of income and profits during the thirties, new sources of Federal tax revenue, for the time being, became relatively more important than income and profits taxes. There was a shift back to indirect taxes, as well as a resort to extensive borrowing.

16–9. Basis of Taxation Shifted from Person to Property. A just basis for tax levies is an issue of primary importance. In former times, when private property, except land, had not been extensively developed, and when inequalities in the distribution of wealth were not so pronounced as at present, the problem of equitable taxation was relatively simple. A capitation, or poll tax, was considered a just tax from the standpoint of the legal authority imposing that levy. Poll taxes were employed by all the American colonies at one time or another; but at present they are a negligible source of tax revenue in the United States. They are the only survival of levies against the person of the taxpayer; all other levies are against either property or occupational incomes.

The rapidly increasing wealth of nations since the Industrial Revolution, the growing inequalities in the distribution of this wealth, the great increase in population, the development of congested centers of population, the increasing interdependence and growing complexity of modern society in general, and the resultant importance of governmental functions, all these have required larger and larger public expenditures. Hence, the problem of equitable taxation has become exceedingly complex and extremely important.

Many diverse opinions have been expressed by writers from time to time as to a just basis of taxation. Some have gone so far as to deny entirely the right of governments to take private property by compulsory levies. They seem to forget that they are secured in their possession of property by the will of the people, expressed through the government, and that it is the governmental authority that decides what shall be private property and to what extent it shall be privately enjoyed and publicly safeguarded.

16–10. Principles of Taxation. *a. Equality-and-uniformity Theory.* A sense of justice requires that the power that a governmental agency exercises over private property shall be based on principles of equality and uniformity. This idea has been incorporated in the Constitution of the United States, which provides that "all duties, imports and excises shall be uniform throughout the United States," but—even more significant—that "no capitation or other direct tax shall be laid, unless in proportion to the census or enumeration hereinbefore directed to be taken." [1] Similar provisions are contained in practically all the state constitutions of the United States.

The importance of the principle that taxes shall be equal and uniform becomes obvious when one considers the many possibilities of political corruption that would exist if one section of the country or a group of individuals could induce legislators to discriminate in their favor in levying certain specific taxes. The application of this principle of equality and uniformity in the administration of equitable taxation, however, has left much to be desired. Let us see whether the rigid application of this principle to present-day conditions would, in reality, imply just and equitable taxation.

Inequalities in the distribution of wealth and income existing in most modern industrial countries would make an equal and uniform tax imposed on a per capita basis rather inequitable, for it would, in reality, impose a relatively greater burden upon the poor than upon the rich. In this connection, it is well to recall the important economic principle of diminishing utility. It is generally conceded that a $10 tax imposed upon an individual with an income of $1,000 a year involves a relatively greater sacrifice of

[1] Art. 1, Sec. VIII, Par. 1.

want satisfaction than a $100 tax payment made by an individual having an income of $10,000 a year. The realization of this fact has resulted in giving legislatures considerable latitude in exempting certain property and income from taxes so that their owners will not be burdened unjustly by the imposition of these taxes.

Other economic factors render impossible the rigid application of the principle of equality and uniformity in taxation. It will be noted in Chap. XXII that at times public monopolies are created for either sumptuary or regulative purposes. In such cases, revenues are a secondary consideration, the primary purpose being to regulate and perhaps to suppress entirely certain socially harmful institutions. Consequently, taxation distinctions and differentials have been utilized by governments for regulatory purposes as well as for fiscal policies.

There is still another reason why the rigid application of the principle of uniformity and equality of taxes is inexpedient. Certain old and established taxes based on this principle, such as the general property tax, although conceded to be inequitable, are permitted to continue in existence, since they have become firmly intrenched in our social and fiscal systems. Consequently, the unequal burden they impose is not apparent to the taxpayer. It has frequently been asserted that an old established tax is no tax at all. However, to plead contentment with existing inequities of taxation by way of justification of them is, in reality, contending that whatever is, is right.

Ours is a dynamic society, in which social and economic conditions are constantly changing. With these changing conditions, standards of justice are likewise being modified from time to time. Equality and uniformity in taxation have gradually come to mean merely that equal conditions must be treated similarly, not that rates of taxation must be uniform for all incomes of various sizes.

b. Specific-benefit Theory. Since the principle of equality and uniformity of taxation no longer conforms to present concepts of justice, because of the manifold changes during the past century and a half, a new principle of justice was developed that became generally accepted by American courts. This principle was based on the maxim that taxes should be apportioned and paid according to the specific benefits derived. In general, it is the basis on which certain public charges, such as prices, fees, special assessments, and the like, are fixed by legislative bodies today.

It has been noted that by far the major portion of public revenue is expended at present to gratify collective, nonmaterial desires, or to promote the general welfare. It is impossible to determine the extent to which a particular individual benefits from such public expenditures.

Moreover, those who are most benefited by public expenditures are often least able to pay for such benefits. This was well illustrated during the

emergency in the thirties, when millions of unemployed benefited from governmental relief expenditures.

Wherever the specific benefit can be approximated or estimated, and wherever recipients of benefits are able to pay for them, it appears to be a justifiable policy to apply the "benefit" principle of taxation. But at best, even if we accept this principle, it can be applied only to a very limited number of payments for public services rendered by governmental units today.

c. Ability-to-pay Theory. In view of this fact, authorities are generally agreed that taxes, in order to be just and equitable, should be apportioned according to individuals' ability to pay. This so-called "faculty" principle of taxation has now come to be regarded as perhaps the soundest basis of taxation. But even if we should accept this principle, the problem of equitable taxation is by no means solved. Many puzzling questions as to how ability to pay shall be measured must be decided.

What constitutes ability to pay? Shall it be measured in terms of income or in terms of wealth? Shall it be measured by units of production or by units of consumption? The answers to these and many similar questions suggest real difficulties in the practical application of the "faculty" principle. If income is to be made the basis for judgment of capacity to pay, we must decide on a definition of income. Shall we differentiate between "earned" and "unearned" income? If wealth is to be regarded as the basis, it must be borne in mind that all forms of wealth do not possess the same degree of productivity. If consumption is to be considered the basis, we must note differences in planes of living of various social classes.

Even though the "faculty" principle appears to satisfy our sense of justice, the countless problems involved in its practical application are apparent. It must remain an ideal of justice toward which we should aspire. No matter what rule for measuring taxpaying ability is adopted at present, it will be discovered sooner or later that it is only approximately accurate. It is doubtful whether any rigid measure of ability to pay can ever be discovered.

Although the measure of ability to pay may be expressed objectively or quantitatively, the subjective or qualitative concept cannot be accurately measured. The former may be evaluated either in terms of monetary units or in terms of units of product; the latter, however, is a problem of subjective valuation. Two individuals with precisely the same amount of wealth, possessing the same degree of productiveness, having the same gross income, spending and saving the same amounts annually, and paying the same tax quantitatively, may yet be affected very differently by such tax payments. The one may have developed a high sense of social responsibility, while the other may look upon all tax payments grudgingly.

At best, it is possible to approximate ability to pay only by external evidences of such ability. The attempt to test ability to pay in terms of the

sacrifice made in the payment of a tax would probably be valid if it could be accurately applied, but no practical method has as yet been devised for applying such a test.

16-11. Taxes Paid out of Income. In the final analysis, all taxes are paid out of income. Income is the flow of benefits from wealth or services accruing to an individual or group of individuals over a period of time. In a pecuniary economy, in which income is measured in monetary terms, governments usually collect taxes in currency rather than in kind. Even when property is confiscated by a governmental agency in payment of defaulted taxes, the government is interested primarily in acquiring money income for such property. It will dispose of the property at sheriff sale, and those who have the income to pay the government for its tax claim are given title to the property.

Only as governments tax away the income that is normally used either to replace or to form new capital may it be said that taxes are levied on capital. Where this is the case, capital either depreciates or does not come into existence, because of such levies. But even here, income is the actual source of tax revenue.

Moreover, if a tax is levied either against wealth, as for example against real estate, or against a person, as by a poll tax, it must be paid out of income realized by the taxpayer. If the tangible wealth, which is taxed, does not yield the requisite income to pay the tax, it will have to be paid out of some other income source.

16-12. Proportional versus Progressive Taxation. Having adopted a concrete objective measure of ability to pay, one is next confronted with the question: Does ability to pay increase in direct proportion to the measure of that ability and, if not, does it increase less rapidly or more rapidly?

In the middle of the last century it was believed by certain economists that capacity to pay taxes increased in direct proportion to income. In other words, the burden of a 1 per cent tax paid on an income of $2,000, after allowing exemption for a minimum of income necessary for physical sustenance, would be equal to a similar tax rate levied and collected on an income of $200,000. Opinions have changed since then, however, and it is now held by most authorities that, in order to arrive at an approximate equality of sacrifice, the rate of taxation, as well as the amount of taxes, should increase as the measure of ability to pay in wealth or income increases. This is known as progressive taxation.

The justification for progressive, rather than directly proportional, taxation lies in the fact that as wealth and income increase, the ease of producing or acquiring more wealth and income increases even faster than at a proportional rate. Moreover, the utility of economic goods to an individual normally decreases as he acquires more of such goods. "It is the first thousand that comes hardest" is an expression with which practically

everyone is familiar. As long as decided inequalities in the distribution of wealth and income continue to exist, the justice of progressive taxation can scarcely be questioned, although the rate of progression will probably continue to be a cause of controversy.

16–13. Incidence and Shifting of Taxes. The incidence of a tax is the place where the tax finally rests, while the shifting of a tax signifies the removal of that tax from where it was originally placed. As noted before, indirect taxes, in the form of customs duties and excise taxes, are usually collected from either importers or manufacturers, with the expectation that they will be shifted by the payer to someone else. The word "expectation" is used advisedly, for it is not always true that the businessman will be able to add the full amount of the tax to his selling price without noting a decrease in his sales. The elasticity of the demand for the product upon which the specific tax is placed, as well as the effect of that particular tax on costs of production and supply price, will determine to what extent, if at all, the manufacturer or importer will be able to pass on the tax to the ultimate consumer. It is also possible that an indirect tax on a primary product may increase, like a snowball, as the production process rolls on.

In our money economy the shifting of taxes must operate through the mechanism of prices. Unless a tax affects price it will normally not be shifted, but will fall where it is imposed. In general, an indirect tax is shifted through a reduction of the supply of the item taxed. Since, as a rule, the demand for so-called "essentials" tends to be relatively less elastic than that for nonessentials or luxuries, the possibility of dealers shifting a tax per unit on necessaries is greater than one on comforts and luxuries. Hence, the poor man bears a relatively greater burden in indirect taxation than does the rich man, the taxes on whose articles of consumption are not so easily shifted by merchants or dealers.

A review of the principles governing costs and values, as seen by individual firms in intermediate periods of production under conditions either of perfect competition or of imperfect competition, or of monopoly, will help to show the effects of various indirect taxes on supply and price. Thus a tax per unit of product (excise tax) will increase marginal costs of all firms producing the article taxed. The higher marginal costs of the highest cost producers, due to the tax, will raise their costs above selling price and so tend to drive them out of business. The resultant shorter supply will cause the price to rise, and sooner or later the tax will be forced on to consumers, in whole or in part, in the form of a higher price on the taxed article.

In cases of imperfect competition or monopoly, a tax per unit of product will likewise raise marginal costs and change the point of intersection of marginal cost and marginal revenue for the individual firm. Hence supply will tend to be reduced and selling price raised. But the elasticity of de-

mand for the product of the particular firm will determine how far the tax will be shifted either forward to the consumer in the form of higher price, or backward to the factors, in the form of lower cost payments, and how far it will be borne by the firm in the form of decreased net profits.

In the long run, if it is found that the net returns to the enterpriser are reduced by the tax because it cannot readily be shifted, capital will not be likely to flow into the industry in question until the latter has recovered sufficiently to show a return approximately equal to that on similar investments in other industries. The gradual adjustment of supply will, in consequence, ultimately result in shifting the tax to consumers, although over a short period of time it may fall primarily on producers. The mobility of labor and capital will be an important factor in determining the duration of time necessary to bring about the requisite readjustment of industry.

16–14. What Is a "Good" Tax? From the point of view of the individual who does not recognize his civic obligations, no tax that affects his pocketbook is "good." But assuming a sense of civic duty and of social responsibility, a tax that cannot be evaded, that cannot be shifted, that is levied in accordance with ability to pay, and that is convenient of payment may be regarded as a "good" tax from the viewpoint of the individual taxpayer.

From the standpoint of society, a tax that does not unduly burden legitimate industrial enterprise, that does not make discriminations among various enterprises except for sumptuary purposes, that will tend to decrease rather than to increase inequalities in the distribution of wealth and income, and the disbursement of which will result in greater collective benefits than if expended individually—such a tax yields distinct social benefits.

Finally, from the point of view of the government making the levy, that tax may be considered "good" which is definite in amount, economical to collect, certain as to time of payment, and productive of revenue.

It is this last consideration that is apparently uppermost in the minds of most legislators charged with imposing taxes. A general sales tax has attained decided popularity among those lawmakers who look primarily to tax yield as the best indicator of its fiscal merits. But, as will be shown later, such a sales tax is distinctly unsound from the viewpoint of both taxpayer and society as a whole.

A "good" tax should therefore be judged from the viewpoints of the taxpayer, society, and the government. In the following two chapters, various Federal, state, and local taxes will be considered in the light of the general requisites of a "good" tax, set forth above.

Guide Questions on Text

1. Explain and illustrate the difference between public receipts and public revenues.
2. How may public revenues be classified?
3. Trace the historical development of public revenues.
4. Explain and illustrate what is meant by "grants-in-aid."
5. Account for the increase in revenues from public-service enterprises in our economy. How do such revenues differ from tax revenues?
6. Distinguish among fees, special assessments, and taxes.
7. "Taxes may be either direct or indirect." Explain.
8. Do direct or indirect taxes offer an economically sounder basis of taxation? Give reasons.
9. What is meant by the equality and uniformity theory of taxation?
10. What factors in our present-day economy make this theory inexpedient of application?
11. "At best, the specific-benefit theory of taxation has very limited applicability." Explain.
12. Show why the "ability-to-pay" theory of taxation has come to be widely regarded the soundest basis of taxation.
13. How may ability to pay taxes be measured? Which measure do you consider best? Why?
14. "In the last analysis, all taxes are paid out of income." Explain and illustrate.
15. What is the difference between proportional and progressive taxes?
16. What is the justification for levying progressive taxes?
17. Explain and illustrate what is meant by the incidence and shifting of taxes.
18. Analyze the characteristics of a "good" tax from various viewpoints.

Topics for Investigation

1. Extent and earnings of self-supporting governmental agencies at Federal, state, and local levels.
2. Competition between public and private enterprise.
3. Changes in relative importance of direct versus indirect taxes in the Federal budget.
4. Inductive studies of the incidence of specific taxes.
5. "Incentive" taxation.
6. Examination into alternative proposals for postwar tax reforms.

Selected References

See Selected References, Chap. XIV.

CHAPTER XVII

FEDERAL TAX REVENUES

17–1. Trend toward Direct Federal Taxes. Fundamentally, as pointed out before, all taxes are levies on income. Through taxation, a portion of the income stream produced by private enterprise is diverted into the public treasury, to be paid out again by the state as money income to those rendering various public services. But the methods employed by governments to divert money income into the public treasury vary considerably. Moreover, the kinds of taxes imposed have undergone many significant changes from time to time. This is particularly true of Federal taxes; but, as will be shown in the following chapter, taxes levied against property values continue to be the primary source of local tax revenues.

Until the beginning of the present century, Federal tax revenues were derived chiefly from indirect taxes in the form of customs or import levies and excise duties on specific domestic commodities. Prior to 1913, there were definite constitutional limitations to imposing direct taxes by the Federal government on any basis other than that of equality and uniformity. In view of these limitations, Congress imposed direct taxes "apportioned among the several states . . . according to their respective numbers" only five times in the history of the national government before 1900. Direct Federal taxes were the exception rather than the rule prior to the First World War.

In 1913, however, the Sixteenth Amendment to the Federal Constitution was ratified by the necessary three-fourths of the states of the Union. This amendment provided that:

> Congress shall have power to lay and collect taxes on incomes from whatever source derived without apportionment among the several states, and without regard to any census enumeration.

In spite of this constitutional provision giving Congress power to tax incomes "from whatever source derived," the Supreme Court of the United States has indicated from time to time that Congress may not impose a tax on incomes derived from interest on state and municipal bonds. Until a further constitutional amendment is passed by Congress and ratified by the necessary number of states permitting the taxation of income derived from such bonds, the phrase "from whatever source derived" will continue to have certain limitations to its applicability.

17-2. Customs Duties. *a. Fiscal Importance.* Prior to the imposition of the corporation profits tax in 1911 and the individual income tax in 1913, customs duties were more productive of Federal revenue than the so-called "internal-revenue duties," which then were chiefly excise taxes. During the 10 years from 1902 to 1911, customs yielded an annual average of 53 per cent of the total tax revenues of the Federal government. Revenues from duties on imports for the fiscal year ending June 30, 1943, on the other hand, were but 2 per cent of the total tax revenues of the Federal government for that year. In 1940–1941, our last prewar fiscal year, they amounted to only 4.7 per cent of the Federal tax revenues.

In general, the relative importance of customs receipts, as compared with other Federal revenues, has decreased with the passage of time. Although import duties showed a moderate, temporary rise during the twenties, they have fluctuated considerably, varying not merely with general business conditions but also with war or peace and with changes in tariff legislation. Import duties declined considerably during the depression in the early thirties, dropping from 602.3 million dollars in the fiscal year 1929 to 318.8 million dollars in 1939, or by about one-half.

b. Fiscal Uncertainty. Customs duties are an unreliable source of Federal revenue, since they are affected by many disturbing influences. In times of a great national emergency, such as war, when governmental expenditures increase considerably, revenues from customs tend to decrease rather than to increase with the need for more funds. For example, after our entrance into the First World War customs receipts dropped from 226 million dollars in 1917 to 182.8 million dollars in 1918, or by 19 per cent. Again in 1943, in the midst of the Second World War, they were about equal to what they had been at the depth of the depression in 1932.[1]

Wars of foreign nations, as well as our own, have likewise adversely affected Federal receipts derived from import duties. With the outbreak of the First World War in 1914, import receipts were 8 per cent less than in the preceding year. As pointed out above, tariff revisions also may cause fluctuations in receipts from customs. The fact that they may decrease at the very time when additional funds are needed to meet urgent public requirements, and that they are relatively uncertain because of the disturbing political influences to which they are exposed, offsets any possible good features of customs duties as sources of Federal revenues.

c. Fiscal Incidence. The common impression prevails that customs duties are largely borne by foreign exporters. The line of reasoning leading to this conclusion runs somewhat as follows: A tax is imposed on an imported article. If the price to the domestic consumer is increased by the amount of the tax, the domestic selling price may be raised to the point

[1] Data on customs duties taken from *Statistical Abstract* of the United States, 1943, p. 242.

where it will be profitable to produce the commodity at home and thus crowd out the foreign competitor, unless he assumes the customs duty by lowering his selling price correspondingly.

The incidence of an import duty, however, cannot be so easily determined. It may be true that over a relatively short period of time the seller or producer of the commodity may be compelled to bear either the major portion or all of the duty imposed on his product, because of the nature of the demand for the commodity in question. But, in the long run, the inevitable readjustments of conditions of supply will tend to shift the burden of customs duties, even as internal excise duties are ultimately shifted, to consumers.

d. Fiscal and Protective Aspects. When duties are imposed on foreign products imported into the United States for the purpose of restricting such importation, it is obvious that they cannot be productive of revenue if they fulfill their full protective purpose. Consequently, a so-called "protective tariff" may not logically be regarded as part of the public revenue system of a country. In general, it may be concluded that, within certain limits, the larger the amount of actual protection to domestic industries, the smaller the resultant revenue to the home government, and the greater the loss to, or burden on, the domestic consumers.

From the point of view of public revenue, therefore, our present tariff system is open to the criticism that the income it affords to the government is out of proportion to the burden it imposes on the taxpayer in the form of higher prices of commodities. Customs duties for fiscal purposes are also open to the objection that they can be evaded, in whole or in part, by smuggling or by misrepresenting articles of import.

Moreover, as compared with internal revenues, import duties are uneconomical taxes to collect. For the fiscal year 1943 the average cost of collecting $100 of various kinds of customs duties was $5.74, while the average cost of collecting internal-revenue taxes was but $0.32 for every $100 collected.

Finally, customs duties are not levied in accordance with the principle of ability to pay. In so far as they are placed on basic necessities, they impose a disproportionately heavy burden on individuals with small incomes; and so they fail to satisfy our sense of justice in taxation. But in spite of these many objections, customs duties will probably continue to play a part in the Federal revenue system of the future, although a relatively less important role than in the past.

17-3. Federal Excise Taxes. *a. Nature.* Excise taxes are those levied on commodities in some stage of production before they reach the final consumer. From the close of the Civil War to the development of Federal income taxes during the First World War, excise duties, such as taxes on alcoholic beverages and tobacco, formed the chief source of all internal

revenue of the Federal government. These taxes are sometimes referred to as indirect taxes on consumption. Although levied on commodities in various stages of production, they are intended to be shifted to the ultimate consumer. Whether they can be shifted, either in whole or in part, will depend upon the effect that the addition of the tax to the selling price of the taxed commodity will have upon demand and supply. In general, it is true that an excise tax will ultimately fall on the consumer.

In the early days of excise duties, attempts were frequently made to levy a uniform rate on all classes of commodities, in the belief that such duties would result in an equal distribution of the tax burden. In our present roundabout system of production, involving many stages in the transition from raw materials to finished products, the administrative difficulties of levying uniform taxes on all classes of commodities seem almost insurmountable. Moreover, because of present inequalities in the distribution of wealth and income, uniform rates on all classes of commodities would result in a disproportionately heavy burden of taxation on consumers of moderate means.

b. Purpose. Excise duties may be employed for several purposes. In the first place, they may be used primarily for fiscal purposes to counteract the effects of certain customs duties. If a government wishes to impose an import duty on a specific commodity for fiscal purposes and at the same time to preserve competitive conditions at home and abroad, it will impose a corresponding duty on the domestic product. Otherwise, the import duty would afford a degree of protection to the home producer, and so defeat the fiscal purpose of the duty.

Secondly, import duties may be imposed for sumptuary purposes. It may seem socially desirable to limit the consumption of certain commodities considered harmful to their consumers. Whenever excise duties are levied for sumptuary or regulative purposes, the fiscal aspects of such duties are of secondary importance, even though they may be very productive of revenue. Familiar illustrations of commodities taxed primarily for sumptuary purposes are intoxicating liquors, tobacco, narcotic drugs, and playing cards. Motives are often so mixed, however, that it is difficult to say which are primary and which are incidental reasons. One may validly question the constitutional authority of Congress to use its taxing power for other than fiscal purposes. Yet it has frequently been employed for regulatory purposes, with relatively little regard for tax revenues. This is particularly true of various excise taxes.

c. Wartime Extension. Partly to provide additional tax revenue, and partly to curtail the consumption of some civilian goods, excise duties were considerably extended by Congress during the Second World War. Under the Revenue Act of 1943, the list of such taxes included levies on the sale of distilled spirits, wines and liquors, tobacco and tobacco products, lu-

bricating oils, matches, gasoline, tires and inner tubes, various toilet preparations, automobiles and automobile accessories, mechanical refrigerators, sporting goods, and a variety of other items.

d. Disproportionate Excise Taxes. Because of the wide use of the automobile in the United States, excise duties on automobiles, motor accessories, and fuels have proved a particularly lucrative source of Federal tax revenue, both in prewar years and during the Second World War. In 1943 [1] Federal taxes on motorists, in one form or another, amounted to 77 per cent of all manufacturers' excise taxes collected by the Federal government, while for the fiscal year 1944 this total aggregated almost 80 per cent. These figures included neither the wartime Federal motor vehicles use or stamp tax, nor state and local taxes on motor fuels and accessories and motor-license fees.

Taxes levied on owners and users of motor vehicles, in the aggregate, are relatively higher than taxes imposed on other items of daily use, such as telephones, radio sets, and various household appliances. Yet it is commonly accepted that the automobile is an economic necessity. Therefore, multiple taxes on motorists, levied by various governmental agencies, violate a basic principle of taxation, namely, that of equality of sacrifice. The benefit principle of taxation can scarcely be said to apply to the many taxes imposed on motorists, because these taxes have been used extensively for other governmental purposes than merely for highway construction, maintenance, and road protection, for which they were originally designed.

e. Pros and Cons of Excise Taxes. Excise duties, in general, possess some favorable features. They are productive of revenue and easy to administer. Moreover, they are economical to collect, fairly certain in amount, and usually payable in such small amounts that the burden imposed is not always felt by the average taxpayer. But excise duties are distinctly objectionable on the ground that they are not levied in accordance with ability to pay. In order to make them productive of revenue, they must be levied on items of wide use, which commonly fall in the category of necessities.

Furthermore, excise duties, if imposed for a short period of time upon specific commodities, are objectionable to the producers of those commodities. They impose an unjust burden upon the manufacturers, who may have to bear the major portion of the duty before the supply will be readjusted so as to shift the tax to the ultimate consumer in the price of the finished product. Excise duties are objectionable also because the incidence of such taxes is difficult to ascertain; they may impose unequal burdens upon different classes of income. Excise duties should, therefore, not be viewed as a major source of Federal tax revenues in our postwar economy, even though they were desirable as wartime measures.

[1] Fiscal year ending June 30.

17-4. Brief Survey of Federal Income Taxation. Although, as previously indicated, all taxes must be paid out of income, the expression "income taxes" has come to be applied specifically to direct taxes on money incomes derived from various sources. The first bill providing a Federal income tax in the United States was passed by Congress on July 1, 1861. It levied a 3 per cent tax on all money incomes above $800. The amount of exemption was subsequently reduced to $600 and a slightly graduated scale adopted. The original tax law of 1861, which expired in 1870, was reenacted for an additional period of 2 years, and then discontinued. While effective, this income tax yielded nearly 25 per cent of the total internal revenue of the Federal government.

The income tax of 1861 was attacked almost immediately on constitutional grounds; it was held that it was a direct tax not duly "apportioned" as provided in the Constitution of the United States. But in 1880 the Supreme Court of the United States decided that this income tax was not a direct tax within the meaning of the Constitution; and so it was declared constitutional.[1]

The next attempt to levy a Federal income tax was made in 1894. The constitutionality of this law was again questioned. The Supreme Court reversed its decision on the Civil War income tax, holding that the income tax of 1894 was direct, and that therefore it had to be apportioned according to population.

In view of this decision of the Supreme Court of the United States, it became increasingly apparent that a direct Federal income tax could be made possible only by constitutional amendment. The agitation for such an amendment began in 1909; it continued until Congress passed such an enabling amendment, which the requisite three-fourths of the states finally ratified in 1913. In spite of this amendment, the constitutionality of that portion of the Federal Revenue Act of 1913 providing for a progressive income tax was contested in the courts. It was contended that the progressive feature of the income tax, classifying taxpayers according to their wealth or income was unwarranted, unjust, and unreasonable, even though the general principle of direct income-tax legislation had been established. The decision of the Supreme Court,[2] however, upheld the law in every respect, even supporting the controversial principle of progression.

Thus, the Federal income tax, after a half century of protest, became an established institution, incorporated in the Federal revenue system of the United States. For the fiscal year ending June 30, 1929, 58 per cent of the total Federal revenue receipts was derived from individual income and corporation profits taxes. But their relative importance as a source of Federal tax revenue declined rapidly during the years of depression follow-

[1] *Springer v. United States,* 102 U.S. 586 (1870).
[2] *Burshaber v. Union Pacific Railroad,* 240 U.S. 1 (1915).

ing 1929. From 1930 to 1939 Federal income taxes averaged only 42 per cent of total Federal tax revenues annually and in 1933 amounted to only 36 per cent of the total. This relative decline was due not merely to a shrinkage in the yield of income and profits taxes, because of the depression, but also to a substantial increase in miscellaneous tax revenues provided under the Revenue Act of 1932. In 1947, on the other hand, personal and corporation income taxes represented about 78 per cent of total Federal tax revenues.

17-5. Federal Income Taxes on Individuals. Federal revenue legislation underwent frequent changes during the depression of the thirties, and particularly during the Second World War. Both rates and bases, on which various income taxes were levied, were modified from time to time, to meet ever-increasing fiscal requirements, and to adapt Federal tax measures to changing economic conditions. In a war emergency, such frequent tax revisions may be necessary, but in times of peace they are undesirable and may accentuate the prevalent economic instability. Table 11, on page 331, presents a general survey of the many Federal tax revisions since 1932, in so far as individual income tax payments are concerned.

a. Basic Features of Recent Federal Income-tax Laws. Tax rates on individual net incomes are a combination of what are called normal taxes and surtaxes. Normal taxes under the Revenue Act of 1932 amounted to 4 per cent of the first $4,000 of net income in excess of "personal credits"—analogous to allowances for normal human "maintenance and upkeep"—and 8 per cent of all net incomes above that sum. Surtaxes were levied at progressive rates, beginning with 1 per cent on net incomes between $6,000 and $10,000, and increasing by gradual steps to 55 per cent on net incomes in excess of $1,000,000.

The Revenue Act of 1934 provided for a single normal tax rate of 4 per cent on net incomes after personal credits, but increased surtax rates progressively from 4 per cent on net incomes, beginning with $4,000, to 59 per cent on surtax net incomes in excess of $1,000,000. While in subsequent Federal revenue acts, down to 1942, the normal tax rate was continued at 4 per cent, surtax rates were stepped up progressively at various intervals, until they reached the wartime rate of 20 per cent on the first $2,000 of net income subject to tax, to a maximum of 91 per cent on net incomes in excess of $200,000. Moreover, the normal tax was increased by a 10 per cent defense tax under the Revenue Act of 1940, thus in essence increasing the normal rate to 4.4 per cent in that year. But this defense tax was discontinued under subsequent wartime revenue acts, while both normal and surtax rates were stepped up significantly in 1942, as is indicated in Table 11.

Furthermore, personal exemptions, which amounted to $2,500 for married couples, and $1,000 for single persons under the Revenue Act of 1932,

TABLE 11. PROVISIONS OF FEDERAL REVENUE ACTS (1932–1948, INCLUSIVE) RELATIVE TO INDIVIDUAL INCOME-TAX PAYMENTS *

(Normal and surtaxes)

Revenue Act of	Applicable to taxable years	Persons required to file returns: Married, Gross net income		Persons required to file returns: Single, Gross net income		Personal exemption: Married	Personal exemption: Single	Credit for each dependent	Earned income credit, per cent of net income	Maximum earned income admitted for credit	Normal rate on net income subject to tax	Range of surtax net incomes in $1,000 units	Range of progressive rates, per cent of surtax net income
1932	1932–1933	$5,000	$2,500	$2,500	$1,000	$2,500	$1,000	$400	None	......	$4,000 @ 4%. Bal. @ 8%	$6–$1,000+	1–55
1934	1934–1935	5,000	2,500	2,500	1,000	2,500	1,000	400	10	$14,000	4%	4– 1,000+	4–59
1936	1936–1937	5,000	2,500	2,500	1,000	2,500	1,000	400	10	14,000	4%	4– 1,000+	4–75
1938	1938–1939	5,000	2,500	2,500	1,000	2,500	1,000	400	10	14,000	4%	4– 1,000+	4–75
1940	1940	2,000	......	800	......	2,000	800	400	10	14,000	4.4% ¶	4– 1,000+	4–75
1941	1941	1,500	......	750	......	1,500	750	400	10	14,000	4%	0– 5,000+	6–77
1942	1942–1943	1,200	......	500	......	1,200	500	350	10	14,000	6% + 5% vic. tax	4– 200+	13–82
1943 †	1943	1,200	......	500	......	1,200	500	350	10	14,000	6% + 5% vic. tax	4– 200+	13–82
											Withholding at source. Current tax payment basis.		
1944 ‡	1944–1945	Per capita $500	......	500	......	1,000 §	500	Normal tax, none.** $500 surtax	None	......	3% ‖	0– 200+	20–91
1945	1946–1947	Per capita $500	......	500	......	Per capita $500	500	$500 normal and surtax	None	......	3%	0– 200+	17–88
											Less 5% of over all normal and surtax		
1948	1948	600		600		600		$600			Reduced on sliding scale††		

* Compiled from "Federal Tax Service," vol. 4, pp. 60,051*f*., Prentice-Hall, Inc., New York, 1946. † Current Tax Payment Act of 1943.

‡ Individual Income Tax Act of 1944. Optional simplified provisions for taxpayers with gross incomes under $5,000.

§ If each had $500 gross income or over. ¶ Included 10 per cent of normal tax as defense tax.

‖ 1943, 5 per cent victory tax repealed.

** Total normal and surtax limited to 90 per cent of net income (1944–1945), and to 85.5 per cent (1946).

†† From 12.6 per cent of income tax in low-income brackets to 5 per cent of income tax in high brackets. Married couples in all states were permitted to split their income under the community property provision introduced.

were reduced to $1,000 and $500 respectively under the Revenue Act of 1944, while credit for each dependent was raised from $400 to $500, and the concept of "dependent" was made more inclusive than in earlier acts.

b. Trend Toward Broader Base and Higher Rates. Since the war program increased the earnings of the lower income classes rapidly, those incomes were subjected to heavier taxes by widening the personal income-tax base, until an estimated 50 million individuals were subject to Federal income-tax payments in 1944. The heavier taxes were not imposed merely to provide additional revenues for financing the war effort, but also to decrease civilian demand for consumers' goods, in the face of many wartime shortages of civilian supply. Moreover the steeply progressive rates on larger incomes minimized the likelihood of there being any wartime millionaires left, after tax payments, in view of a 91 per cent surtax rate on surtax net incomes in excess of $200,000.

c. Pay-as-you-earn Basis and Collection at Source. In the face of popular pressure, Congress amended the Revenue Act of 1942 by passing the Current Tax Payment Act of 1943. This placed Federal personal income taxes very largely on a "pay-as-you-earn" basis, rather than levying income taxes in any one year on the income received during the preceding year, as had been the case under former revenue acts. Thus it became possible for millions of taxpayers to discharge their tax liability to the Federal government as they earned their incomes.

The Act provided also for the collection of personal income taxes, either weekly, bimonthly or monthly, by withholding at the source. Employers have been held responsible for deducting the tax from pay rolls and making quarterly returns to the Collector of Internal Revenue of the taxes withheld. The major portion of individual income-tax payments was thus put on a "pay-as-you-earn" basis during the war. There is reason to believe that this sound tax reform will be a permanent feature of the Federal tax revenue system in the postwar economy.

Withholding at the source establishes a closer relationship between the time of earning an income and that of paying taxes thereon. Moreover, it decreases the possibility of tax evasion by individual taxpayers. Again, it distributes tax liability over many payment intervals and thus decreases the difficulties to taxpayers of making lump sum payments at quarterly intervals. Taxpayers are also better able to budget their personal expenditures in terms of their take-home pay, without worrying about having to set aside funds for tax payments. Finally, taxation at the source facilitates the settlement of decedents' estates by diminishing income-tax liability at time of death.

d. Simplification of Reporting Form. The Individual Income Tax Act of 1944 was designed to relieve the majority of income-tax payers of the necessity of computing their taxes and filing returns. A new concept,

"adjusted gross income," was incorporated in the Act. A normal tax of 3 per cent was levied against this gross income after allowing for certain business deductions, but no personal credits or exemptions were allowed for dependents. Income recipients with adjusted gross incomes below $5,000, regardless of source, were permitted an optional simplified tax computation under the 1944 law, which, when employed, relieved millions of taxpayers of the necessity of filing tax returns. Thus, while the Federal income-tax base during the Second World War was vastly extended, the optional simplified tax computation applied to some thirty million taxpayers.

e. Postwar Reduction of Income Tax. Shortly after the close of the war, Congress passed the Revenue Act of 1945, reducing Federal taxes on individual incomes and corporation profits for 1946 by an estimated 6 billion dollars. This represented the first Federal income-tax rate reduction since 1929. Some 12 million former income-tax payers in the lower income brackets were removed from the tax rolls of the Federal government.

The wisdom of this tax reduction at a time when the Federal budget was still unbalanced, and when excessive spending power in the hands of the public was continuing the threat of inflation, was questioned by many economists. But political expediency at times must yield to economic soundness. The fear of mass unemployment as a result of discontinuance of war work influenced Congress to yield to the popular pressure for downward income-tax revision immediately after the conclusion of the Second World War.

Further efforts to reduce Federal income taxes were made in 1947 and 1948. Two proposals for income-tax reduction were passed by Congress in 1947; but primarily because of the inflationary threat growing out of releasing additional consumer demand at a time of full employment by reducing taxes, these measures were vetoed by President Truman. The vetoes were sustained by Congress. But in 1948 another bill to reduce Federal taxes on personal incomes by an estimated 4.8 billion dollars became law in spite of a presidential veto.

This tax legislation was regarded unsound by many in view of the continued inflationary pressure on prices in 1948 growing out of an excessive monetary demand for goods. Prospective increased governmental demand for funds to finance both domestic and international commitments, in the face of reduced taxes, carried the threat of further budgetary deficits. A sounder fiscal program would have sought to maintain Federal tax rates at their high levels and to exercise rigorous governmental economies, with a view to further reduction in the national debt out of budgetary surpluses.

f. Summary and Conclusion. Table 11 presents a brief summary of the individual income-tax provisions of Federal revenue acts since 1932, normal and surtax rates, tax liability, personal exemptions, and credits for

dependents. It shows the steeply progressive individual tax rates applicable to personal incomes during the Second World War.

While the equity of progressive taxation in the face of pronounced inequalities in income distribution may not be seriously questioned, the rates of progression may be such as to impair the formation of capital out of voluntary saving and investing.

17–6. Corporation Income Tax. *a. Legislation.* Not only have individual net incomes been subject to Federal income taxes since 1913, but corporate incomes also have been taxed. As early as 1909, an "excise tax" on corporations, measured by net corporate profits, was imposed by the Federal government. When our first modern individual income-tax law was passed in 1913, the corporation income tax, in the form of a tax on net corporate profits, was incorporated therein. The tax rate on net corporate incomes has been changed under subsequent laws. The Revenue Act of 1935 adopted the innovation of slightly progressive rates on corporate incomes for taxable years following Dec. 31, 1935. This principle of progression in taxes on corporate net incomes, subject to tax, was continued in modified form in subsequent revenue acts (see Table 12, on page 335).

b. Normal and Surtax Rates. Under Federal tax laws in effect during the war income taxes levied on corporation profits were divided into regular income taxes with normal and surtax rates and "excess-profits" taxes. Corporations having a net income of $25,000 or more a year were subject to a normal tax of 24 per cent, with a surtax of 10 per cent on the first $50,000 and 16 per cent on all additional net income.

c. Wartime Excess-profits Tax. The excess-profits tax was a flat rate of 90 per cent on all excess profits, as compared with prewar profits, or as computed on profits in excess of a certain rate on an approved capitalization. But total Federal taxes on corporation income could not exceed 80 per cent of the surtax net income. Moreover, the Revenue Act of 1942 provided for a postwar refund of 10 per cent of excess-profits taxes paid. Corporations were also permitted to average out gains and losses over a 3-year period in computing their tax liability in any one year. Several optional methods were provided in the Revenue Act of 1942 for computing the amount of excess profits, but with the repeal of the excess-profits tax in 1945 after the close of the war, they now have mere historical significance.

Congress yielded to the general demand for the repeal of this excess-profits tax on the grounds that its continuation into the postwar period would retard the reconversion program and restrict investments in new peacetime projects.

The justification for an excess-profits tax in times of war can scarcely be applied to a peacetime capitalistic economy, in which the "profits" motive is viewed as the mainspring of business activity. There is a popular resentment against "wartime profiteering" by both business corporations and individuals who may have enriched themselves as a result of big gov-

TABLE 12. PROVISIONS OF FEDERAL REVENUE ACTS * (1932–1945, INCLUSIVE) RELATIVE TO CORPORATION NORMAL AND SURTAXES †

Revenue Act of	Applicable to taxable year	Net income subject to tax	Tax rate, per cent
1932	1932–1933	All	13.75%
1934	1934–1935	All	13.75%
1936	1936–1937	Domestic corporations ‡	
		First $2,000 to over $25,000	8% progressive to 15%
		Surtax on adjusted undistributed net income, first 10% of net income progressive to over 60%	7% progressive to 27%
		Specific credits on adjusted net incomes under $50,000	
1938	1938–1939	Domestic corporations	
		First $5,000 of net income progressive to $20,000 to $25,000	12.5% progressive to 16%
		Over $25,000 with optional alternative	19% − (16.5% of dividends received + 2.5% of dividends paid)
1940 Second Act	1940	Domestic corporations	
		Under $25,000 (as above)	13.5% progressive to 17%
		Over $25,000 + Defense Tax	22.1% + 10% of income tax
1941	1941	Domestic corporations	
		Under $25,000 (as above)	15% progressive to 19%
		Over $25,000	24%
		Surtax on net income to $25,000	6%
		Surtax on net income over $25,000	7%
1942	1942 to date	Domestic corporations	
		Under $25,000 (as above)	15% progressive to 19%
		Over $25,000	24%
		Surtax on net income to $25,000	10%
		Surtax on next $25,000	22%
		Surtax on net income over $50,000	16% of entire net income

* Adapted from "Federal Tax Service," vol. 4, pp. 60, 0.76*f.*, Prentice-Hall, Inc., New York, 1946.

† Not including war profits and excess-profits taxes first imposed under the second Revenue Act of 1940 at rates ranging to 50% on adjusted excess-profits net income over $500,000, and raised to 95% on adjusted excess-profits net income over $500,000 (with over-all corporation income-tax limitation to 80% of surtax net income) under Revenue Act of 1943. Repealed under Revenue Act of 1945.

‡ Rates on nonresident and resident foreign corporations as well as banks and trust companies omitted.

ernmental war orders. Moreover, to permit war "profiteering" to run its course might also induce wage earners to demand a bigger share of the swollen war incomes and so increase the inflationary pressure or demands for consumption goods. Hence there are good reasons for levying an excess-profits tax in times of war. But these can hardly be said to be valid in our peacetime economy so long as it is possible to maintain competitive conditions and to curb monopoly profits.

d. Criticism of the Taxation of Corporate Income. In Federal income-tax legislation enacted since 1913, the attempt is made to treat corporations, partnerships, and individuals alike. The legal interpretation that a corporation functions as a "natural person" is retained in the Federal income-tax law. Thus, the term "person" is defined to mean "an individual, a trust or estate, a partnership, or a corporation."

In the sense in which the concept "income" is applicable to individuals, it cannot possibly be applied to corporations, without considerable confusion of thought. Individuals have net monetary incomes that they can employ either to purchase present enjoyments or gratifications, or to save for the future. Corporations, on the other hand, are legal entities, creations of the state, ultimately benefiting individuals who derive incomes from them; and being artificial, legal creations, the psychological significance of enjoyable income to individuals (a flow of commodities or services to gratify human desires) is inapplicable to them. Corporations have receipts, expenditures, profits, and losses, but not real income that is consumed by real persons, as, for example, by individuals who own corporate securities and receive money income in the form of interest and dividends from corporations. But in spite of these important differences between individuals and corporations, the Federal Revenue Act of 1934 provided slightly progressive rates on net corporate incomes; and this theory of progression in taxing corporation profits was continued in Federal revenue legislation through the Second World War.

Specific exemptions and progressive rates of taxation levied on net incomes of corporations have no relationship in principle to similar provisions pertaining to individual net incomes. One corporation, having net profits in any one year of $100,000, may distribute these among a few individuals of large means. Another, with precisely the same net profits for the same taxing period, may apportion those among several hundred stockholders of moderate means. To allow the same exemptions and to impose the same rates of taxation on both net corporate incomes is unjust. This inequity is only partially offset by the graduated scale of surtaxes on personal incomes. However, with every further increase in surtax rates it tends to become less pronounced.

e. Practical Administrative Difficulties. Certain practical difficulties in the administration of a corporation profits or income tax must also be in-

dicated. How is net profit or net income of a corporation to be determined? If figured on invested capital, how is the amount of invested capital to be ascertained? No uniformity in accounting systems exists at present that would make possible an accurate comparison of "net incomes" of different enterprises for taxation purposes.

The tax on net earnings of corporations has been characterized as follows:

> To avoid serious inequality and evasion the tax on net earnings would require for administration a thorough examination into the accounts of every corporation taxed, together with strict rules how these accounts should be kept. . . . It would be a continual source of irritations between the corporation and the taxing officials. . . . The practical difficulties in the way of imposing a tax on net earnings seem overwhelming.[1]

In view of both theoretical and practical objections to either normal or surtaxes on net incomes of corporations, it is debatable whether they should form a permanent part of the Federal revenue system. From the point of view of revenue yield, they have been very productive, for corporations are numerous and large; but from the point of view of economic justice, they are inequitable, for they impose an unequal burden on industrial enterprise. Moreover, taxes on corporate profits can be evaded by an undue increase in many items of expenditures, such as salaries, reserves for depreciation, concealed investments, and the like. In how far, if at all, corporation profits taxes should, therefore, be made a permanent feature of the Federal revenue program in our postwar economy will be considered later in this chapter.

17–7. Federal Estate and Gift Taxes. *a. Nature and Provision.* A Federal estate tax was first adopted in 1916; it was further expanded under the Revenue Act of 1921. Such a tax is levied by the Federal government upon the transfer of property at the death of its owner. An estate tax differs from an inheritance tax in that it is levied against the decedent's undivided estate, regardless of the amount of individual inheritances or the relationship of beneficiaries. State inheritance taxes, on the other hand, are commonly based on separate legacies, and their rates usually differentiate between several classes of heirs. Every state in the Union except Nevada has either estate- or inheritance-tax laws. Both estate and inheritance taxes have minimum exemptions and progressive rates.

The Federal estate tax, while applying to the decedent's entire estate, allows for various deductions, such as funeral expenses, administration claims and public bequests, exemptions of small estates, and certain credits for state inheritance taxes. The Federal estate tax is composed of two separate rates: the basic tax computed at 1926 rates with an exemption

[1] Report of the Special Commission on Taxation of Corporations, State of Connecticut, 1919.

of $100,000; and an additional tax at current rates, with an exemption of $60,000. The former ranges from 1 per cent on the first $50,000 of the net estate above $100,000 to 20 per cent on the net estate in excess of $10,000,000. The latter ranges from 3 per cent on the first $5,000 of the net estate above $60,000 to 77 per cent on the net estate in excess of $10,000,000. Credit is allowed for state death duties of various types, but not in excess of 80 per cent of the basic estate tax, after deducting gift-tax credits.

b. Pros and Cons of Estate Taxes. The common arguments advanced in favor of a reduction, or even abandonment, of the Federal estate tax are to the effect that highly progressive rates on large estates tend to destroy individual initiative and thrift and so result in a net loss to society. The assumption behind this argument is that estates will be represented by tangible wealth rather than accumulated bank balances. If held as idle cash rather than as investments, they would not have contributed to increasing social benefits but would rather have contributed to creating unemployment. It is also contended that the estate tax is objectionable because it is levied on capital values and not on income. Lastly, it has been charged that the estate tax is designed to equalize the distribution of wealth, and thus savors of communism.

All such popularly presented arguments against a Federal estate tax are of doubtful validity. But some valid objections to the estate tax as a fiscal measure may be advanced. Its yield is very irregular and uncertain. It is therefore an unreliable source of tax revenue. In 1927, estate and gift taxes combined yielded 100 million dollars; whereas in 1933, with higher progressive rates than in 1927, the yield was only 34 million dollars; but in 1943 Federal estate and gift taxes produced nearly 450 million dollars in tax revenues.

To minimize the inducement to evade the estate tax by a transfer of property before death, the 1935 amendment to the Federal Revenue Act of 1932 provided a gift tax at progressive rates equal to three-fourths of the Federal estate-tax rates, after a specific exemption of $30,000.

As fiscal measures, Federal estate and gift taxes embody many features of a "good" tax enumerated in the preceding chapter. From the standpoint of the taxpayer they are burdenless and cannot easily be evaded. They are levied according to the ability-to-pay principle of taxation. From the viewpoint of the government, however, as noted above, they are objectionable because they are not certain as to time and amount. Their fiscal importance, moreover, will tend to decline in view of the steeply progressive, individual income-tax rates, which in all likelihood will be a permanent feature of the Federal tax structure. Without large incomes to "invest" in estates, large estates will likewise tend to decline.

17-8. Postwar Federal Tax Revenues. *a. Further Shift to Direct Taxation of Income.* In the preceding pages the more important sources of Federal tax revenues have been surveyed and evaluated. Their relative importance in the Federal tax structure has undergone decided changes, both in the interwar period and during the Second World War. Individual net income taxes and taxes on corporation profits have become the primary sources of Federal tax revenues, while customs duties and excise taxes play relatively minor roles in fiscal affairs. Direct, rather than indirect, taxes are relied on more and more by the Federal government. This is in accordance with sound principles of taxation, for it establishes the incidence of taxation in accordance with ability to pay.

b. Increased Burden of Taxation. During the period between the two world wars the yearly Federal budget averaged slightly below 5 billion dollars. But in the period after the Second World War, once the transition to a peacetime economy has been made, Federal expenditures, as forecast by various authorities, may range from 20 billion to 25 billion dollars annually. This would be four to five times the prewar yearly Federal expenditures. These estimates do not include social security taxes, which by 1950 will have reached around 3.5 billion dollars, assuming no extension of the social security program beyond that existing in 1945. State and local taxes may be expected to amount to about 10 billion dollars annually in the postwar years, giving a total of possibly 35 billion dollars that will have to be provided each year out of the national income to pay for various services of government. This is the equivalent of around 28 per cent of a potential annual net national income of 125 billion dollars at 1943 prices. The postwar upward movement in the price level, of course, necessitates upward adjustment of these estimates.

17-9. Future Federal Tax Policy. In the light of these considerations, it becomes apparent that the prewar Federal tax policy and tax program will prove inadequate to meet postwar Federal fiscal needs. A sound, long-range, Federal fiscal program should therefore (1) widen the tax base, as compared with prewar years; (2) simplify the tax structure; and (3) remove discriminatory taxes, which may have a retarding effect on private business activity.

a. Wider Tax Base. It has been estimated that of a postwar net national income of 125 billion dollars, 36 per cent or about 45 billion dollars may be made taxable personal or individual income, after making $500 per capita personal exemption and various other legal deductions, and allowing for tax-exempt income and income not reported. Of the taxable income, according to estimates made by the Committee on Postwar Tax Policy,[1]

[1] "A Tax Program for America," p. 22, Committee on Postwar Tax Policy, New York, 1945.

upward of 36 billion dollars, or 81 per cent, will be received by those with net taxable incomes of $5,000 or less annually. If all net taxable incomes in excess of $5,000 were to be taxed away, they would not meet more than about one-third of the estimated annual Federal fiscal needs after the transition period.

Reliance primarily on high individual surtaxes to finance a major portion of Federal expenditures after the war is out of the question, not only because of their sheer inadequacy but also because of their effect on the supply of venture capital. It will be necessary to continue heavy normal personal net income taxes in postwar years at a basic rate possibly four to five times the 4 per cent prewar normal tax rate.

In addition to the high normal personal income-tax rates, progressive surtax rates should be continued, but, as previously suggested, at somewhat reduced rates of progression as compared with wartime rates.

b. Simplified Tax Structure. The Revenue Act of 1945 provided for a single graduated personal income-tax rate to replace the former complex normal and surtax rate structure. This simplification of the income-tax rate scale should be made a permanent feature of the Federal tax structure. Furthermore, uniform per capita exemptions, as provided in the 1945 Act, should be continued in the postwar period, instead of the diversified personal credits and exemptions for dependents, as provided in former revenue acts (see Table 11). These personal exemptions should be adjusted from time to time to allow for substantial changes in the cost of living.

The withholding principle and the payment of taxes on a current basis, as introduced during the Second World War, should be retained as permanent features of our postwar income-tax structure. It has been contended that widening the income-tax base by lowering personal exemptions makes more people tax conscious, while stoppage at the source, sooner or later, would destroy this tax consciousness. Workers, more concerned with their "take-home" pay, lose awareness of their tax liability. But the advantages of simplified tax payments for wage earners, by stoppage at the source, and the decreased likelihood of tax evasion, are advantages that seemingly outweigh any possible loss of "tax consciousness" on the part of employees.

Since Federal taxes on corporation profits have been very productive of revenue, there is little likelihood that they will be abolished entirely in the postwar era. But a single tax on corporation net profits should displace the variety of corporation taxes imposed by the Federal government, largely as war measures. Such a uniform tax on net incomes should preferably be levied at the same rate as the basic personal income-tax rate.

c. Nondiscriminatory Taxes. If established on sound principles of taxation, the postwar Federal tax program would seek to eliminate discrimination by double taxation, and to abolish those taxes that retard legitimate

business enterprise. Income that has been taxed as corporate income by the Federal government, for example, should not be subjected to normal or basic personal income-tax rates again when received as dividends by individuals. Progressive rates, above the basic or initial individual income tax rates, should be levied against dividends received. For reasons previously stated, a uniform, flat rate, preferably the same as the initial individual income-tax rate, should be levied on corporation net income, if it is to be taxed at all.

17–10. Specific Proposals Concerning Federal Taxation. *a. Taxing Stockholders and Corporate Earnings.* The suggestion has been made that all net earnings of business corporations, regardless of their distribution, be taxed to individual stockholders. Thus stockholders would be required to report the earnings per share of stock owned by them, and pay the basic and progressive rates on their net incomes in accordance with their income status, including earnings on their holdings of stock.

Individual income-tax payers are not permitted to deduct savings from their net income before computing their Federal income taxes. Undistributed corporation profits are analogous to savings of income by stockholders, even though at law a corporation is a being separate and apart from the stockholders. The theoretical soundness of regarding corporation net profits as earnings of stockholders, and taxing them accordingly, may not be questioned, but there are both legal and administrative obstacles to instituting any such tax reform.

b. Normal Tax on Corporate Earnings with Deduction by Stockholders. As a practical compromise, and with a view to minimizing discriminatory taxation against recipients of dividends, it has been proposed that corporations be required to pay taxes at the normal or basic individual income-tax rate only on undistributed net profits, while stockholders pay taxes on dividends in accordance with their income status, as provided in individual income-tax schedules.

Again corporations might pay a flat rate on their net profits before dividends and stockholders be given credit for the proportionate taxes on their stock earnings withheld at the source. Income recipients in the lower brackets, moreover, could be given a refund of any excess taxes paid by the corporation on their share of earnings.

c. Lower Surtax Rates. A downward revision of surtax rates on net personal incomes would tend to induce a portion of the larger individual incomes into private investment, by allowing a higher net return, after taxes, on so-called "venture capital." Under surtax rates prevailing in 1947, a stockholder in the $8,000 to $10,000 net taxable income bracket who invested $1,000 of his income in a new corporate venture, expecting the corporation to earn 10 per cent on the investment, might get less than 3 per cent net return. If the corporation actually earned $100 on the $1,000

investment (assuming net corporate income of $50,000 or more), it would first have to pay $40 in Federal corporation income taxes. After allowing for normal additions to surplus, the remainder, possibly $42, paid to the stockholder, would be subject to individual normal and surtax rates in the above net income bracket, leaving the taxpayer a net yield on his investment of 2.83 per cent. If, however, the $1,000 had been invested by a person with a net taxable income between $150,000 and $200,000, under the foregoing conditions, the net yield on his investment, after Federal taxes, would have been 0.875 per cent.[1]

The inducement to invest in "venturesome" projects on the part of recipients of larger incomes is obviously not very great under these conditions. They will, in all likelihood, continue to show liquidity preference, holding their savings as idle cash, thereby contributing to the creation of unemployment by retarding the circuit flow of money incomes.

d. Adjustable Tax Plan. In general, individual income taxes, levied in accordance with a simplified rate structure and as far as practicable withheld at the source, should be made the primary source of Federal tax revenue in our postwar economy. Moreover, basic and surtax rates should be adjusted from time to time to conform with changing business conditions, rising with expanding business and declining as business activity diminishes. Such an "adjustable tax plan" would provide a helpful corrective of economic instability, and integrate Federal tax and fiscal policy in general with the broader objectives of economic stabilization and continued high levels of productive employment in our postwar economy.

e. Credit for Insurance Premiums. Insurance is bought for protection and not for speculative profit. Failure to provide for the contingencies of life results in destitution or dependence. Consequently, insurance is socially desirable and should be encouraged by government through modest tax credits. Premiums paid for all types of personal insurance against death, illness, or accident might well be allowed as income-tax credits, at least up to $100 a year or 5 per cent of one's income. At present, contributions to organized charities are deductible up to 15 per cent of one's income, but insurance premiums paid for the protection of one's own self or family are not recognized by income-tax laws. Allowable deductions for medical expenses also might be more generous.

Guide Questions on Text

1. What were the chief sources of Federal tax revenues prior to the First World War?
2. What provision of the Sixteenth Amendment to the Federal Constitution made it legally possible to levy progressive Federal income taxes? How?

[1] Illustration adapted from "The Twin Cities Plan. Postwar Taxes," p. 6, St. Paul. Minnesota, 1944. Rates provided under Revenue Act of 1945 applied.

3. Point out the defects of customs duties as a major source of Federal tax revenue.

4. "A protective tariff does not logically fit into the fiscal program of the Federal government." Do you agree? Reasons.

5. Why does the Federal government levy excise taxes?

6. What were the reasons for expansion of excise taxes during the Second World War?

7. Present the arguments for and against the extension of excise taxes in our postwar economy.

8. Trace the development of individual income taxation in the United States prior to 1913.

9. Point out the significant changes in Federal individual income-tax laws since 1932 relative to:

   a. Persons required to file returns.

   b. Personal exemptions.

   c. Normal tax rates on income subject to tax.

   d. Range of progressive rates of surtaxes.

10. In 1943 the Federal individual income tax was placed on a "pay-as-you-earn" basis. Explain how this was done and the reasons for doing so.

11. The wisdom of tax reduction by the Federal government shortly after the close of the Second World War was seriously questioned by many economists. Why?

12. What significant changes were made in the provisions of Federal revenue acts during the Second World War, relative to corporation income taxation? Why were these changes made?

13. "The justification for an excess-profits tax in times of war can scarcely be applied to a peacetime capitalistic economy." Do you agree? Reasons.

14. Criticize the theoretical and practical application of the principle of progressive taxation to net corporate profits.

15. Present the arguments that have been advanced for and against levying progressive Federal estate taxes.

16. Analyze three proposals that have been advanced as the basis for a sound long-range Federal fiscal program in the postwar era.

Topics for Investigation

1. Critical analysis of the concept "income" as used in Federal income-tax legislation.

2. Tax avoidance versus tax evasion and methods of dealing with them.

3. Economic consequences of progressive taxation of corporation profits.

4. Reasons for changes in personal exemptions and credits in Federal income-tax legislation.

5. Reasons for changes in the relative importance of direct and indirect taxes as sources of Federal tax revenues.

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CHAPTER XVIII

STATE AND LOCAL TAXES

18–1. Sources of State and Local Revenues. In 1941, the sources of revenues of state and local government, exclusive of grants-in-aid, were approximately as shown in Table 13.

TABLE 13. STATE AND LOCAL GOVERNMENT REVENUES, 1941 *
(In million dollars)

Sources	State	Local	Total	Per cent of total
General property tax	268	4,224	4,492	49
Sales and gross receipts taxes	1,033	98	1,131	12
Pay-roll taxes	901	5	906	10
Corporation and business taxes	586	181	767	8
Individual net income taxes	225	2	227	3
Inheritance, estates, and gift taxes	118	1	119	1
Highway-users taxes	1,346	31	1,377	15
Special assessments		102	102	1
All others	30	64	94	1
Total	4,507	4,708	9,215	100

* Adapted from U. S. Department of Commerce, Bureau of Census, "Statistics of Cities, 1941" and "Financing Federal, State and Local Governments, 1941."

Taxes levied against users of public highways have for many years been a major source of state revenues, while the general property tax has provided the chief source of local revenues. In 1941 the former aggregated almost 30 per cent of total state taxes, whereas the latter represented 90 per cent of the taxes collected by local governments. For many years the general property tax was the largest single source of tax revenue.

During the Second World War, however, the quantitative importance of the general property tax was exceeded by both individual and corporation net income taxes. This situation is likely to continue in the postwar era, particularly in so far as personal income taxes are concerned.

18-2. General Property Tax. *a. Nature of Tax.* The general property tax is levied at uniform rates on the assessed value of nearly all forms of real and personal property in a given taxing district. It has become an established feature of our modern tax system and promises to continue as the primary source of local tax revenues in years to come. But in spite of its fiscal importance as a source of tax revenues, there is no tax that has evoked more adverse criticism. These objections can best be understood in the light of the historical development of the general property tax, which reveals significant changes in the interpretation of property as a source of tax revenue.

b. Development of the General Property Tax. Direct property taxes in the form of levies on land were imposed in ancient Greece and Rome. As other tangible forms of property rights evolved, this tax was extended to include them also. Intangible property, in the form of claims to wealth, such as stocks, bonds, and mortgages, were more recently included in taxable property. Thus, the concept of a general property tax gradually crystallized.

This evolution of the general property tax out of an earlier tax on land can be traced clearly in modern nations. Early English taxes, for illustration, were primarily land taxes, but as new forms of material wealth developed, they were included in the ever-broadening concept of taxable property. The same process can be observed in the early history of continental European countries.

The American colonies introduced a tax on property at a comparatively early date in their history. In 1654, Peter Stuyvesant, of New Amsterdam, succeeded in having an "honest and fair tax" placed on "land, houses or lots, and milch cows or draft oxen." Under English rule, the principle of assessing every person in proportion to his aggregate property became the commonly accepted principle of taxation in the colonies. Various kinds of property, both real and personal, have, in the past, been considered evidences of taxpaying ability in practically every state and local community of the Union. Even today, as noted above, the general property tax is the chief source of local tax revenues.

c. Economic Changes Affecting Property Concept. In primitive agricultural communities, property was mostly in land. Hence, the amount of land owned was regarded as an approximate indication of ability to pay taxes. But the profound economic changes of the past century and a half have modified considerably this earlier belief that property, and especially property in land, is an accurate index of ability to bear taxes.

What are some of the significant changes that have affected our concept of property as a basis of taxation? In the first place, the ownership of, or legal title to, property has been largely separated from the actual possession of wealth in modern industrial society. Second, this legal ownership,

particularly in corporate property, has been widely diffused. Third, different classes and kinds of property have developed different degrees of productivity. Fourth, not all types of property are easily discoverable for purposes of assessment. Fifth, many persons derive their incomes from sources other than the ownership or possession of property. In view of these changes, the concept of property as indicative of taxpaying ability has become untenable. Many forms of property have evaded the general property tax entirely; others have been inequitably assessed. Consequently, the practice of making the general property tax a levy against real estate, including land and improvements on land which can neither hide nor run away, has been adopted by most local governments.

History thus ever teaches the same lesson. As soon as the idea of direct taxation has forced itself into recognition it assumes the practical shape of a land tax. This soon develops into the general property tax which long remains the index of ability to pay. But as soon as the mass of property splits up the property tax becomes an anachronism. The various kinds of personalty escape, until finally the general property tax completes the cycle of its development and reverts to its original form of the real property tax.[1]

18-3. Defects of the General Property Tax. *a. Difficulty of Assessment.* Let us analyze a little more closely the chief defects of the general property tax just outlined. One of the outstanding objections to this tax is the inequality of assessment of property. As a rule, a final tax rate is established on the assessor's value of the property in a given taxing district. If all property were uniformly and equitably assessed, *i.e.*, valued for tax purposes, a tax on such a value would conform, in a general way, to the principle of uniformity in taxation. Most tax laws of states and municipalities provide that property shall be assessed at its "fair cash value." For example, the constitution of the state of Ohio provides[2] that:

Laws shall be passed, taxing by a uniform rule, moneys, credits, investments in bonds, stocks, joint stock companies, or otherwise, and also all real and personal property, according to its real value in money.

How is this "real value in money" to be ascertained? Uniform methods or standards of valuation are being employed more and more by assessors of properties in many urban communities. But "rule-of-thumb" or "guess" methods are still applied by many assessors, who lack the necessary qualifications to make accurate appraisals of taxable properties. It is debatable whether any standardized method of evaluating all forms of property can be employed.

It is possible, however, to assemble, analyze, and interpret uniformly the evidences of property values. Some assessors regard sales price as an ac-

[1] SELIGMAN, E. R. A., "Essays in Taxation," 8th ed., p. 56, The Macmillan Company, New York.

[2] Art. XII.

curate indication of true value in money, but others arrive at the value by capitalizing the realized net money income. Still others trust to their judgment, based on experience, while some merely guess at the value of various properties.

The employment of definite systematic methods for determining the actual value in money of definite kinds of property is a comparatively recent practice. Wherever such systematic methods are employed in assessing taxable property, it is customary to call them "scientific" assessments. This should, however, not be interpreted to mean that assessments are based on "slide-rule" interpretations of value. The element of human judgment is basic to the valuation process, and cannot be read from a "slide rule." But systematic methods of assessing require that the many-sided evidences of value be carefully analyzed and uniformly applied by assessors in valuing property for tax purposes. Failure to do so by many assessors is one of the major defects of the property tax.

Official reports reveal the fact that properties in various taxing districts have been assessed at from 25 per cent of their alleged real value in money to over 100 per cent. A uniform rate of taxation based on such inequitable assessments must inevitably result in injustice to the taxpayer. In some cases, boards of equalization or revision of taxes are appointed to correct this evil. Nevertheless, inequitable assessments continue. Even though property were equitably assessed in one taxing district but not in another, injustice would result from apportioning taxes among several taxing districts, based on such property values, if taxed at a uniform rate.

b. Burden on Real Property in Urban and Rural Areas. Another defect of the general property tax lies in the fact that it places an undue burden of taxes upon real property, primarily in the form of land and permanent improvements on land, while many forms of personal property are allowed to escape taxation, in whole or in part. Inasmuch as personal property, roughly identified with movable objects more closely related to personal use than to land, is largely held in cities, the consequence is a tendency toward shifting a disproportionate portion of the tax payments to rural districts.

c. Abuses of Administration. An incentive to dishonesty and perjury is given by the general property tax, especially in so far as intangible personal property in the form of various claims to wealth is concerned. Wherever attempts have been made to require taxpayers to declare their personal property under oath, the inducements to perjury have become very pronounced. Reports of state and local tax commissions abound in such statements as the following, which, although made 50 years ago, still contains a large element of truth:[1]

[1] Report of Special Committee on Taxation of the Cleveland Chamber of Commerce, 1895, p. 10.

The existing system is productive of the gravest injustice; under its sanction, grievous wrongs are inflicted upon those least able to bear them; these laws are made the cover and excuse for the grossest oppression and injustice; above all and beyond all, they produce in the community a widespread demoralization; they induce perjury; they invite concealment. The present system is a school of evasion and dishonesty.

d. Double Taxation. Still another objection to the general property tax is found in the fact that it frequently results in double taxation. Double taxation is levying two taxes upon the same base, either by the same or by different governmental agencies.

If all property were equally subjected to two or more taxes, the injustice of double or multiple taxation would not be so pronounced. But when two taxes are imposed upon one class of property, while another bears but one tax or possibly escapes taxation entirely, the inequity of a general property tax becomes apparent.

If, for example, one tax is imposed on the value of plant and equipment of a corporation, and another on evidences of ownership (certificates of stock) in the corporation, there is a clear case of double taxation on the same base. Again, when securities are taxed by one jurisdiction, while the actual wealth represented by these securities is taxed by another jurisdiction, double taxation also results.

The twofold use of the concept "property" to designate both tangible wealth and evidences of ownership of such wealth is apparent in much of our tax legislation. At law, stocks, bonds, promissory notes, mortgages, and similar evidences of ownership are all regarded as intangible property, while material objects or actual items of wealth are spoken of as tangible property. Thus, the term property is commonly applied to both concepts.

It is obviously unjust to tax both debtor and creditor, the former on the value of his material wealth, regardless of creditor claims against it, the latter on his credit instrument. If a person, having purchased a house and lot for $10,000, of which amount he borrowed $7,000 on a mortgage, pays a real-estate tax on the $10,000 value of his home, while the mortgagee pays a personal-property tax on his evidence of the claim against the real estate for $7,000, a tax is collected on a value of $17,000, where in reality only $10,000 worth of real estate exists.

If, on the other hand, debt deduction were permitted, before levying against tangible wealth, what would prevent an individual from mortgaging the value of his entire real estate to some fictitious person, and thus escape the entire property tax? It is a relatively simple matter to create fictitious debts against real estate. Corporations, which have issued bonds to the extent of the face value of their outstanding capital stock, could possibly escape one-half of their general property tax, if debt deduction were allowed.

So long as land and other property were owned in fee simple they could, of course, be taxed only once, and that to the owner. . . . In the early and simple organization, all the rights of property were characteristically vested in the user. Today these various rights in property have become widely diffused and hopelessly entangled for the tax administrator.[1]

e. Regressive Feature. Lastly, the general property tax is often regressive, *i.e.*, the rate decreases as the base increases. Not that the legal tax rate becomes less as property values increase, but inadequate assessment of complex properties taxed at uniform rates is analogous to decreasing rates, because of underassessment. A small amount of property will usually be in the form of visible realty or personalty, which cannot easily escape the eye of the honest assessor. But as property, in the legal sense of the word, accumulates, it takes on more and more intangible forms, which can easily be concealed.

f. Summary.

If we sum up all these inherent defects, it will be no exaggeration to say that general property tax in the United States is a dismal failure. . . . Practically, the general property tax as usually administered is beyond all doubt one of the worst taxes known in the civilized world. Because of its attempt to tax intangible as well as tangible things, it sins against the cardinal rules of uniformity, of equality and of universality of taxation. . . . It is the cause of such crying injustice that its alteration or its abolition must become the battle cry of every statesman and reformer.[2]

18–4. Reasons for Retention of General Property Tax. If one accepts this opinion he may well ask, Why has the general property tax been tolerated on our statute books? Several reasons may be cited for its continuation to the present day. In the first place, the resources of the United States have been such that tax levies on property have not imposed a particular hardship upon the people in general. But during the economic depression of the thirties the hardship made itself seriously felt and thus invited extensive protests.

Second, the value of land in the past has increased so rapidly that the imposition of the tax on real-estate values has been offset, in whole or in part, by the increment in land values, while, as has been noted above, an increasing amount of personal property has successfully evaded the tax.

From the administrative point of view, the tax has been retained, since it offers a fruitful source of revenue and is relatively easy to administer. Moreover, the general property tax has become an established institution in many parts of the United States, and it is often contended that an old

[1] JENSEN, J. P., "Public Finance," pp. 246*f*, The Thomas Y. Crowell Company, New York, 1924.

[2] SELIGMAN, *op. cit.*, pp. 34, 62.

established tax is no tax at all. This contention, however, does not justify the retention of a tax that, in its present form, is unsound in theory and unfair in practice.

18–5. Suggested Reforms of the General Property Tax. Inasmuch as three-fourths of the general property tax in the United States can be resolved into a tax on real-estate values, a tax on this form of property, equitably administered, should prove an acceptable substitute for the general property tax. The personal-property tax should be abolished, since it is frequently impossible to locate such property for purposes of assessment.

Again, the assessment of real estate for tax purposes should be taken out of the hands of political appointees and placed under the jurisdiction of those who have qualified for the office of assessor by passing appropriate civil-service examinations. Furthermore, state and county agencies for review and equalization of assessments and taxes should be established on the merit system, and not, as is frequently the case, on the basis of political affiliation.

In assessing real estate, a careful distinction should be made between land, as such, and improvements on land. In this connection it will be well to review the basic principles underlying the valuation of land and of reproducible goods. Whereas land should be evaluated on the basis of its present actual and prospective maximum utility, as reflected in optimum demand relative to the available economic supply of various grades of land, buildings should be evaluated on the basis of their reproduction costs less accrued depreciation.

The confusion resulting from applying both the legal and the economic concepts of property to the general property tax should be removed by distinguishing carefully between actual physical products (economic wealth) and property rights or interests (legal wealth). If these two concepts continue to be applied, the present ambiguity in general-property-tax legislation will remain.

In the final analysis, the assumptions that the ownership of property measures taxpaying ability and that all property may be regarded alike for purposes of taxation are unsound. But the tax on real-estate values has become an established institution in most local communities, and to advocate its entire abolition might be viewed as somewhat radical. The above recommendations for reforming property taxation in the United States, if carried out more widely, would materially decrease many of the manifest injustices in the existing general property taxes.

18–6. Suggested Tax on Land Values. *a. Advantages:* Some communities have proposed to "untax" the value of improvements on land by levying a progressive rate, graduated according to its value, on unimproved land. The theoretical justification of this proposal runs as follows. Land

is the gift of nature, the heritage of mankind. Its actual value, not due to the discovery of a natural resource, is a social product, resulting from increased demand for land with increasing population and prosperity. In any event, the unearned increment from land is ordinarily not due to any direct productive contribution of the landowner. The individual, as such, is not responsible for differences in land values, nor for increases therein. Consequently the expropriation or recovery of this socially created value for the benefit of the community would not be a levy on human labor or on industrial activity.

Improvements on land, on the other hand, are the product of human labor, and a tax on them imposes a definite burden on taxpayers. Social reform should seek to untax as much as possible the products of human labor and to impose taxes on naturally or socially created land values, where they would be relatively burdenless.

Furthermore, a tax on land values, representing the capitalized economic rent of land, cannot be shifted but must be borne by the owners of the land. By economic rent is meant the net income derived from a certain piece of land. A purchaser of such taxed land buys it subject to the tax; he will normally not pay more than that price which reflects his judgment as to the capitalized value of the net income, after the tax has been deducted.

If, for example, the full economic rent of a tract of land were $1,200 annually, the capitalized value of this rent would amount to $40,000, assuming a 3 per cent rate of capitalization. But if one-half of the economic rent were absorbed annually by taxes, the capitalized value of the tract would tend to decrease to $20,000. As more and more of the rent was absorbed by taxes, the value of the tract to the landowner would decrease still further until finally all of the socially created land value had been appropriated through taxation for communal benefits. The market value of the land would approach zero.

It is assumed, to be sure, that the landowner, whose economic rent is taxed more and more, will not be able to increase the rent charged his tenant, for if he had been able to do so before imposition of the tax, economic self-interest would have prompted him to do so.

b. Alternative Types of Land-value Tax. The foregoing analysis suggests several different types of land-value tax that may be adopted. In the first place, a definite rate of taxation may be imposed on the present economic rent of land but not great enough to absorb the entire net income from land. As rental values increase with increasing demand for land uses, the revenues derived from such a tax would likewise increase, but not all of the increase in rentals would be consumed by taxation.

Second, only the future increment in land values, reflecting increasing economic rent with increasing demand and relative fixity of supply, may be taxed away. Thus, the landlord would retain his claim on the present

capital value of his land, but not on the anticipated further increases in land values.

Finally, the full economic rent may be taxed away, thus destroying the value of the legal claim that individuals now have to landed property. Private-property rights in land would thus become practically meaningless. Exclusive possession of the land would be continued, but the private appropriation of economic rent would be abolished. It is this latter proposal that is the basis of the single-tax doctrine, as formulated by Henry George in his famous work, "Progress and Poverty."

18–7. Single Tax. *a. Fundamental Premises.* The single tax, as expounded by Henry George and his disciples, is not merely a tax measure, but a plan for social reform. It is based on the fundamental premise that the use of land is a natural right of all people that cannot be alienated.

Man, as an individual, has a right only to those things which he has produced. Since everyone has an equal claim to land, the landlord's title to it need not be respected. While these landlords continue to own land and exact tribute from the rest of mankind, poverty, with all its accompanying evils, will persist.

To remedy these ills, land must be made common property. The taxing away of the annual rental value of land would do away with private property in land. Society should appropriate economic rent by letting out land to the highest bidders in lots of suitable size. The landowner has no special claim to the product of social efforts. "Private property in land has no warrant in justice." [1]

It has at times been contended that economic rent thus appropriated would suffice to meet all the ordinary requirements of governments. No taxes levied on the product of human labor would be necessary. Hence, the name "single tax."

b. Objections to the Single Tax. According to single-tax doctrine, an individual has a natural right to the fruits of his labor but not to the gifts of nature. But can anyone determine how much of the value of a brick house is the former and how much is the latter? Is it possible to differentiate between the fruits of labor and the gifts of nature in the crops of a farm, yielded after cultivating and fertilizing the soil, sowing the seed, and harvesting the crop? In all these processes, capital and labor, as well as land, are jointly utilized.

The public requirements of two communities, even though exactly the same in size, differ considerably. One community may develop rapidly, the other slowly. The revenues derived from the single tax on land values would not necessarily keep pace with the various collective needs of the communities.

[1] "Progress and Poverty," Book VIII, Chap. 2.

The single tax would also be inflexible, since it could not be increased to meet urgent public requirements in times of a national emergency. Federal expenditures, alone, largely due to war emergencies, are such that the total economic rent of land, if taxed away entirely, would cover only a small fraction of necessary Federal outlays. Moreover, it is doubtful that the tax would yield enough revenue to pay for the services of local governments. Again, the single tax, if adopted, would involve the wholesale confiscation of private property in land.

There has been disagreement among commentators as to whether the single-tax doctrine, as expounded by Henry George, involves the complete abolition of private ownership of land or merely the serious restriction thereof. On this point Henry George himself is not altogether clear or consistent. He suggests that private property in land has no warrant in justice and advocates at one stroke the abolition of all private titles to land, "declaring all land public property, and letting it out to the highest bidders in lots to suit." On the other hand, he holds elsewhere that he is not advocating the confiscation of private property in land, but only confiscation of rent. "Let the individuals who now hold it still retain, if they want to, possession of what they are pleased to call their land. Let them buy and sell, and bequeath and devise it." [1]

Even if private property in land be continued under George's system of single tax, one may well ask, Who would want to buy land from the ownership of which one could derive no personal gain? And how would private ownership be possible if all private titles to land were abolished?

Lastly, the single tax would be difficult to administer, particularly in our highly developed urban areas, since it is practically impossible to distinguish between capital invested in permanent improvements on land and land itself. To appropriate the entire income from improved land would be to impose a tax, in part, on the fruits of human labor.

Because of these obvious weaknesses and difficulties of the single-tax proposal, it is doubtful that it will ever meet with popular approval in the United States. Nevertheless, partial taxation of the unearned income from land is well developed as a program of fiscal and social reform. The taxation of land values has been advocated as a supplement to, rather than as a substitute for, other forms of taxation. But this cannot be considered a single tax, in the sense in which the expression is used by the disciples of Henry George.

18–8. State Inheritance Taxes. The first state inheritance tax in the United States was adopted in Pennsylvania in 1826. Since then, other states have from time to time passed inheritance-tax laws, until today (1948), as we have seen, every state in the Union except Nevada derives a portion of its revenue either from inheritance taxes or from estate taxes.

[1] *Ibid.*

Most of these state laws have certain basic features and common advantages, which we shall now examine.

a. Basic Features. In the first place, state inheritance taxes are ordinarily not "estate" taxes, such as the Federal estate tax, discussed in the preceding chapter, since they are usually taxes based on separate legacies and not on the estate as a whole. Secondly, legacies to direct heirs, such as parents, wife, husband, or children of the legator are commonly taxed at a lower rate than those to collateral heirs. Furthermore, a minimum exemption is generally allowed. As a rule, gifts to religious, educational, and charitable institutions are not taxed. Most schedules of rates are progressive, increasing with the size of the bequest and the remoteness of the relationship.

b. Justification. On what grounds can highly progressive tax rates on collateral inheritances be justified? It is contended that, from the point of view of the beneficiary, an inheritance tax is burdenless, since whatever he receives is so much unearned income to him. Again, from the point of view of the testator, the desire to leave a large estate to distant relatives or friends plays an unimportant role in gratifying his acquisitive tendencies or his productive activities. Tax or no tax on collateral inheritances, he would, in all probability, be inclined to work to accumulate wealth just the same. The incentive to produce and to save is not destroyed by such a tax on collateral inheritances.

The argument is frequently advanced that inheritance taxes discourage the accumulation of property. This contention is valid only with some qualifications. If the rates of inheritance taxes are moderate, and a reasonable minimum is exempt to assure a continuation of the accustomed standard of living to the direct heirs of the testator, it is doubtful that progressive rates will appreciably retard saving or impair industrial productivity. Only excessive rates or multiple taxation of the same property will tend to discourage the accumulation of property.

Some critics question the right of the state to levy heavy taxes on inheritances, contending that such taxation represents a confiscation of private property. They seem to confuse the right to possess property and to enjoy its benefits during life with that to bequeath property at death. The former right is ancient; but the latter is essentially modern. It is not necessary to go far back into history to discover that there was a time when property left at the time of death reverted to the state or to the ruler as a matter of course.

When the owner of property dies, his ownership ceases. The disposition of the property subsequently becomes a matter of social, rather than individual, significance. No one has an absolute right to property, although most modern states safeguard the rights of certain direct heirs in the estates of the deceased, "but always under definite limitations designed to promote

the general well-being."[1] The deceased cannot be permitted to determine what shall be done with his property, regardless of the interest of the living. It does not appear unjust for the state to assume the right to a share in the property that it has safeguarded during the lifetime of the deceased, to be employed for the benefit of the whole community. The share thus appropriated by the state is neither a burden on the deceased, because he has passed beyond this vale of tears, nor an unfair imposition on the heirs, because it is not the product of their labors. For a general discussion of theories of private property the reader is referred back to Part One.

c. *Present Confusion in Death Duties.* One of the outstanding weaknesses of inheritance- and estate-tax legislation in the United States today is the lack of uniformity, not only in respect to rates but also in respect to the bases on which these taxes are imposed. Some states levy the inheritance tax at the domicile of the deceased, others at the location of the wealth, while still others impose the tax on evidences of ownership such as stocks, bonds, and mortgages. Many states use a combination of methods, which still further increases the confusion of bases and rates, as well as the conflict of agencies and parties.

It is obvious that such chaotic conditions should be remedied. Uniform inheritance and estate taxes, levied on a common base, can be secured only by cooperation among the various states and the Federal government. If the individual states would mutually agree to abolish their present inheritance taxes and allow the Federal government to tax estates uniformly, the latter returning a certain percentage of the taxes thus collected to the individual states, the outstanding objections to the present system of administration would probably be removed.

Furthermore, rates could be made to vary uniformly, not only with degree of relationship and size of estate, but also with the number of times the property passes through inheritance. In other words, the rate might be made progressive, increasing each time the property passed from testator to beneficiary, until after several generations the original estate would finally be absorbed entirely by the state.

It has been suggested that such a plan would not discourage the accumulation of wealth as much as do many of the present inheritance taxes. The main difficulty is to obtain the consent of the states to such a proposal. The remaining problem would be to devise a practical basis for administering an estate tax by the Federal government and for redistributing the revenue thus collected.

18–9. Special Corporation Taxes. Most states impose special taxes on different kinds of corporations, in addition to subjecting corporate property to some form of property tax. These special taxes are justified on the

[1] SEAGER, H. R., "Practical Problems in Economics," p. 541, Henry Holt and Company, Incorporated, New York, 1923.

grounds that they are a return for the special privileges extended to corporations by these states. The benefit principle of taxation, rather than the faculty principle, is basic.

a. Types and Bases of Tax. Either the privilege to come into existence or the privilege to perform certain functions is taxed. The former is usually called an "incorporation fee," and the latter a "franchise tax." When special privileges, such as the use of public highways by public-service corporations, are taxed, the levies thus imposed are referred to as special-franchise taxes.

Corporations are artificial creations of the state, functioning at law like natural persons. On what basis shall these legal creatures be taxed, if at all? Shall they be taxed uniformly, regardless of size, or shall they be subjected to taxes according to the amount of their capitalization? If the latter basis is adopted, how is capitalization to be ascertained? These few questions illustrate the complexity of the fundamental theory of corporate taxation. Let us next examine some of its practical aspects.

b. Problems of Administration. Most large corporations are engaged in interstate activities. Which state is to have jurisdiction over the corporation for purposes of taxation? A corporation is chartered under the laws of state A, transacts the major portion of its business in states B and C, and is controlled by stockholders mostly residing in state D, who have mortgaged the corporation property to bondholders living in state E. What amount of the franchise tax on this corporation should be collected by each one of the five states? Again, to what extent shall corporations be taxed by local authorities in the districts where their material wealth is located?

These are but a few of the many questions arising from an attempt to impose franchise taxes by individual states and local governments on miscellaneous corporations. How can these difficulties be overcome and the resulting confusion clarified? Although economists and lawyers have, as yet, devised no generally accepted solution for this problem, it is commonly agreed that greater centralization of administrative authority in taxation would be helpful in promoting uniformity of method and in reducing conflict of agencies.

The general tendency in modern governments appears to be in the direction of increased centralization of governmental control. Taxation is no longer a purely local problem, particularly in so far as it affects corporations. The integration of industry into units extending their activities far beyond local and state borders, even beyond national boundaries, has to a large extent destroyed the possibility of equitably taxing any one industry by a local government. The plan of levying a general estate tax and distributing a part of the proceeds to the counties or municipalities has much to commend it. This proposal might be applied similarly to the taxation of corporations engaged in interstate business.

c. Present Prospects and Future Possibilities. Federal chartering or licensing of corporations,[1] accompanied by a Federal corporation-franchise tax, based either on corporate profits or on invested capital, carefully ascertained by systematic assessment of property, may become a reality in the future. Such a Federal franchise tax might then be redistributed among the states, either according to population or according to relative importance of the corporations to various localities, as indicated either by assessed value of corporate property or by volume of business transacted.

The logical plan for the immediate future, however, is to tax corporations on their receipts, or on a valuation equal to the stock and bonds, for state purposes, and to tax them on their real property for local purposes, with the understanding that in the case of public service corporations this local real estate tax should be subject to central assessment in accordance with the Unit Rule. The question of the division of the yield of the corporation tax may safely be left to a consideration of the particular needs, in each individual case, after the principle has first been applied to other state-wide taxes.[2]

18–10. State Sales Taxes. *a. Development and Significance.* The fiscal emergency confronting state and local governments, growing out of the economic depression following 1929, necessitated the search for new sources of tax revenues. As noted before, an increasing number of states adopted personal-income taxes during the depression. But because of state constitutional obstacles to imposing a progressive personal net income tax in many states, as well as political opposition and the uncertain yield of such a tax, sales taxes of various kinds were widely advocated as sources of state tax revenues.

In 1945, 23 states were imposing general sales taxes, either involving levies on retail sales alone, or representing taxes on practically all sales. In most states in which a sales tax was adopted after 1929 it was regarded as an emergency measure, growing out of the search for new revenues, and not as part of a permanent state fiscal program. But once introduced, states have been reluctant to give up sales taxes as sources of tax revenues.

Their ease of collection, fiscal certainty, and continuous flow have made them a very acceptable source of tax revenues in an increasing number of states. In 1941, general sales taxes represented approximately 12.8 per cent of state revenue receipts, while general sales and gross receipts taxes combined totaled 23 per cent of state tax revenues.

b. Advantages of State Sales Taxes. State sales taxes produced considerable revenue within fairly short periods of time despite their relatively low rates. In 16 of the 23 states, the rate in 1945 was 2 per cent of retail sales, while in one state it was 1 per cent.

[1] Discussed in Chap. XXIII.

[2] SELIGMAN, *op. cit.*, p. 314.

The cost of administering a sales tax relative to revenue produced varies inversely with the rate of taxation. It has been estimated that a 3 per cent retail-sales tax can be administered for less than 2 per cent of its revenue yields, while a 1 per cent tax, on the average, will cost a little over 3 per cent of its revenue yield to administer.[1] In 1941, state administrative costs of sales taxes amounted to 2 cents per dollar collected. The costs of collecting sales taxes, in general, are relatively low. Moreover, sales taxes yield a constant and certain flow of revenue.

c. Disadvantages of Sales Taxes. But the administrative advantages of sales taxes should not make us lose sight of the objections to such taxes. They are unjust, because they are not levied in accord with the principle of ability to pay. Second, they are grossly discriminatory, for in so far as they cannot be shifted, because of the nature of demand for a commodity, they are distributed according to gross income among producers, which is no measure of taxpaying ability. Third, sales taxes give a bounty to large integrated industries, to the disadvantage of small industrial units. To the extent that large integrated concerns decrease their intermediary purchases in the process of converting raw materials into consumers' goods, they will have a distinct market advantage over small independent businesses. Sales taxes will thus encourage vertical and horizontal combinations in industry and so crowd out small competitive producers. Fourth, the burden of sales taxes will ultimately be shifted to the consumer, and so fall most heavily on the mass of population having small and moderate incomes.

Finally, general sales taxes are distinctly regressive. Individuals with small incomes may spend all of their income for consumers' goods subject to such taxes. But large-income recipients would be in a position to save a part of their income, and pay the tax only on that portion spent for current purchases. Assume, for example, a 2 per cent retail-sales tax. The person with a $1,000 annual income would very likely pay a tax of $20 a year, since he would spend the entire amount for consumers' goods. But a person with a $50,000 annual income might save and invest half of this amount, and spend the rest for current consumption. His tax on purchases would thus be $500. Although greater in absolute amount, the sales tax of the richer individual would be only 1 per cent of his income, whereas that of the poorer individual would be 2 per cent of his income, or twice as great a proportion.

A careful survey of the arguments for and against state sales taxes warrants the conclusion that the social objections to such taxes far outweigh their possible administrative advantages, even though in a war emergency they may be desirable as means of curtailing civilian consumption. But

[1] "Sales Taxes: State vs. Federal," p. 11, Interstate Commission on Conflicting Taxation, Chicago, 1935 (mimeographed research report).

they do not fit into our peacetime economy, the continuous functioning of which depends on maintenance of high levels of consumption.

18-11. National System of Taxes. *a. Present Lack of Uniformity.* In the preceding pages, the chief Federal, state, and local taxes have been examined and evaluated. The criticism has frequently been voiced that there is no uniformity among the various taxes imposed by different political divisions of the country. Each political unit appears to levy that tax which offers the best possibilities of revenue yield and the greatest ease of collection. Some states levy a variety of taxes, others but a few. Some stress indirect taxes, others favor direct taxation. Some consider expenditures (sales) as the best measure of taxpaying ability, others regard either gross or net money income as the most equitable criterion. Some believe in retaining old established taxes, no matter how inequitable they may be at present; others revise old tax laws and make them conform more nearly to changing economic conditions. How can order be brought out of such chaos and a unified tax system be developed? Certain recommendations may be made in this connection.

b. Suggested Reforms. 1. A sufficiently large variety of taxes should be employed to reach the taxpaying ability of all groups. A single tax, no matter on what base it might be levied, would probably not reach all sources of income.

2. Specific sources of revenue should be assigned to the several political units making up the United States. Personal net income taxes should be made the main source of Federal tax revenue. Various types of gross income and sales taxes, if employed at all, should be reserved for state governments. On the other hand, the tax on real property should continue to be the primary source of local taxes. Such allocation of specific taxes to various governmental units is essential to minimize the levying of double or multiple taxes on the same base. As a further means of reducing multiple taxation, centrally collected and locally shared taxes would remove the multiplication of taxes on certain classes of subjects, as, for example, on motorists.

3. The principle of progression in taxation should be extended only to the point where it will not destroy private initiative or encourage evasion. It is inconsistent to make evasion possible, for instance, by investing in tax-exempt securities, and at the same time to levy high progressive rates on large incomes.

4. The general property tax should be abolished. A real-estate tax, based on accurate systematic assessments, should be substituted for it.

5. Tangible wealth and property interests should be clearly differentiated in tax legislation, to avoid the ambiguity resulting from a confusion of the two concepts.

6. Taxes should be levied as far as possible where the burden will be relatively insignificant, and where the possibility of shifting will be reduced to a minimum. For this purpose, direct, rather than indirect, taxes should be encouraged, in spite of the many administrative advantages of indirect taxes.

7. Corporation taxes in the form of franchise taxes of various kinds should either be abolished or be made uniform throughout the states. They should be levied by state authorities, and certain shares duly distributed among local taxing districts.

8. Taxes should be levied, as far as possible, on unearned incomes, such as economic rent, inheritance, and monopoly profits, where they will be burdenless, and where they cannot be shifted.

9. Greater cooperation among the several states and with the Federal government cannot be recommended too strongly. A joint Federal and state tax commission, charged with standardizing and systematizing Federal, state, and local taxes, would accomplish many beneficial results, if not made a political tool. The vastly increased importance of Federal taxation in our national economy in the postwar era emphasizes the need for integrating the Federal tax program with that of state and local governments. Not only equitable taxation, but also the future of state rights and local autonomy rest on a soundly devised national system of taxation.

10. It has been suggested that personal income taxes be left to the Federal government and that, in return, all death duties be left to the individual states. If that is not feasible, the general plan (but not specific rates) of income-tax laws should be similar. In the matter of death duties, at least, this division must be clear; namely, that the states should tax only inheritances received and the Federal government only estates bequeathed. The principle of reciprocity should be extended so that no state should tax the inheritance, *i.e.*, the transfer of property, of the citizen of another state, even though some of his inherited property may lie outside the state in which the heir resides, and on which he should pay inheritance tax to his state of domicile and not to both states.

c. Conclusion. One fact cannot be repeated too often, namely, that we are living in a dynamic world. In our onward movement, certain historical institutions become antiquated and rather out of place in a world of action, where he who stands still is but retarding the advance of civilization. The problem of equitable taxation is no longer a local problem, but one that has attained national importance. It can be treated adequately only by approaching it from the viewpoint of the continued welfare of the nation as a whole.

Guide Questions on Text

1. Indicate the chief sources of state and local tax revenues.
2. Trace the development of the general property tax in the United States.

3. Analyze some of the significant changes in our economy that have affected the concept of property as a basis for taxation.
4. What are the chief defects of the general property tax?
5. What are the reasons for retaining the general property tax in our taxing system?
6. Analyze the proposed reforms of the general property tax.
7. What is the theory behind land-value taxation?
8. "The single tax is not merely a tax measure, but a plan for social reform." Explain.
9. Criticize the single-tax proposal.
10. On what grounds can highly progressive inheritance taxes be justified?
11. What is the chief weakness of inheritance-tax legislation in the United States?
12. Analyze the problems arising out of attempts by states to tax corporation property.
13. Present the arguments for and against state general sales taxes.
14. Criticize the United States system of taxation. Is it a system?
15. Formulate a sound program of tax reform. Be specific in your suggestions.

Topics for Investigation

1. Trends in real-property taxation for local tax revenue purposes.
2. Development of land-value taxation in American municipalities.
3. Personal income taxes as sources of state tax revenues.
4. Centrally collected and locally shared taxes.
5. Methods of assessing real property.

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See also Selected References, Chap. XIV.

Part Six

PROBLEMS OF LAND UTILIZATION

CHAPTER XIX

URBAN LAND UTILIZATION

19–1. Nature and Importance of Land. Land, like labor, is a primary factor in production. It is the natural source, not only of economic wealth and mechanical energy, but also of many nonmaterial want satisfactions that add joy and color to life, such as invigorating climate and beautiful scenery. Land is fundamental to life itself, for without its life-sustaining qualities, existence on our planet would be inconceivable. Access to the utilization of land, therefore, has been an important factor in many great historical movements, from the time of the rovings of the nomadic shepherd kings in ancient Egypt to those of our own American pioneers. The promise of land won many peasants over to the French Revolution and to the more recent Bolshevik revolution in Russia.

Land consists not merely of the solid surface of the earth but of all those natural resources and productive forces over which man has control by virtue of his possession of the earth's surface. These include fertility of soil, natural vegetation, mineral resources, water power, and strategic location.

The question as to whether air or space above the solid earth's surface should be regarded as land has received considerable attention in recent years, with the advent of air navigation and the radio. Under the system of private ownership of land, it is a matter of considerable importance to know just what is included in that to which one has legal title.

19–2. Air Rights. In the past, ownership of land has usually been interpreted to include the right to the space above the surface owned. In accordance with this interpretation, an advertisement in a New York newspaper once offered "for sale the permanent right of passage at an altitude exceeding 1,000 feet in the air space over a tract of land on Long Island." But a number of states have enacted legislation declaring their sovereignty of the air; they have qualified land ownership by reserving the right of flight.

In some instances, sovereignty of the air has been either granted to, or assumed by, the Federal government. There is no uniformity in state laws pertaining to air rights. Such agencies as the United States Chamber of Commerce, the Committee on Aviation Law of the American Bar Association, and the Committee on Aeronautics of the National Conference

of Commissioners of Uniform State Laws have for some time been striving to obtain uniform state air-rights legislation. The question has not yet been finally answered as to whether air space will be considered public property, similar to navigable waters, or whether title of the surface owner to the space above it will be maintained.

It is commonly believed that possession of the solid surface of the earth also gives man control over the space above it, and that, in consequence, air is a part of land. Limitations to such legal ownership of this air land, however, have not yet been fully defined, either in legislation or by court decisions. The Air Commerce Act of 1926 fixed the altitudes for navigable air space above 500 feet from the ground in rural communities and above 1,000 feet in municipalities, except when landing or taking off.

19-3. Effective Land Utilization. Problems of land utilization arise when land is either improperly or inadequately used. In a price economy, the test of adequate land utilization is maximum profitability. Adequate utilization may be regarded as synonymous with economical land utilization. Wherever, and to the extent that, such is not the case, the result is economic waste.

The proper or improper use of land is reflected in the economic and social consequences of such utilization. Thus the too rapid expansion of agricultural lands in the United States under the Federal land policy, to be discussed in the following chapter, has aggravated our farm problems. Improper use of land in many urban districts has helped to create the problem of blighted areas, while the rapid and often wasteful exploitation of natural resources has raised the issue of conservation of natural resources. The former will be discussed in this chapter, the latter in Chap. XXI.

19-4. Social Control over Private-property Rights in Land. Most land in capitalistic countries like ours is privately owned. This means that the landowner is protected in his legal right to derive benefits from that which he owns. The exercise of this right by individual owners frequently creates land-utilization problems, because of a conflict between individual and public interests. For illustration, the building of an automobile service station at a desirable street intersection in a residential area may mean the most profitable use of this particular site for the individual owner. But this may have a depressing effect on residential-property values in the neighborhood and thus result in a net economic loss to the community as a whole. *Whose* profitability thus becomes an important consideration in connection with urban land utilization.

a. City Zoning. City zoning represents an attempt to regulate individual usages of urban land with a view to safeguarding property rights of others and to promoting the welfare of the whole community. It makes for orderly urban growth, achieves efficient land utilization, minimizes losses to the community due to overcrowding, and tends to stabilize urban land

values. There is both a restrictive and a protective aspect to city zoning. While it may restrict individuals in the uses of their property, this may protect the interests of the entire community.

b. Eminent Domain. Frequently the right of eminent domain, *i.e.*, appropriation of private property for public use, is exercised to meet the problem of socially desirable land utilization. The rights of society transcend those of individuals, and when a public need exists for privately owned land, that land may be appropriated by due process of law and with just compensation to the owner.

19–5. Physical and Market Supply of Land. For purposes of clear analysis, a distinction should be drawn between the physical and the market supply of land. The former is limited by the extent of the earth's surface. Only a portion of it, however, has either actual or potential usefulness. This represents the market supply. Problems of land utilization center around this market supply not merely because that land is scarce, but also because of the frequent conflict between private and public interests in its utilization in an economy recognizing the right of private property in land.

By limitation of market supply is meant a relative scarcity of land suitable for those uses for which there is the greatest demand. This scarcity is accentuated by the fact that land is immobile in character and varied in its characteristics. Land has various degrees of usefulness for different purposes, and one type cannot be substituted for or converted into another type. Furthermore, land is subject to the operation of the law of diminishing returns, which prevents the best areas from easily supplying all our needs. This natural limitation necessitates a resort to poorer lands and a more intensive cultivation with lower incremental yields on better lands.

In view of the vast physical supply of land there would be no scarcity of market supply, and hence no economic problems of land utilization, if land were mobile, if all land were of one grade, and if the law of diminishing returns did not operate. But these are assumptions contrary to fact.

No matter how valuable a certain tract of land may become because of its favorable location in the heart of a city, its physical supply in that locality cannot be increased. The owner of such a tract has a monopoly possession, and the price that he can exact for it is limited only by the demand for it. Such land is used for commercial purposes and not for farming, but it may similarly be cultivated intensively by the construction of tall office buildings, just as farmers may cultivate their soil intensively by applying more labor and capital to it.

Because different locations in a city possess varying degrees of desirability for different purposes, prices paid for the uses of land also vary considerably. Thus, one foot of land, fronting on the main street in the commercial center of a large city and extending 100 feet in depth, may be

valued at $20,000, while 100 acres of fertile farm land not many miles removed from the city may be purchased at the same price.

But there is an important factor that helps to counteract scarcity of market supply of urban land. That is the available physical supply. If land in the center of a city becomes too costly, this price differential will serve as an inducement to make new tracts of land available for use, by constructing new streets and highways, by removing topographical obstacles, and by developing and improving transportation facilities. Witness, for example, the trend toward suburbanization in recent years. More and more extensive, as well as intensive, urban land utilization has been resorted to for purposes of both business location and habitation.

19–6. Urban Growth and Increasing Diversification in Land Uses. The rapid growth of population in industrial countries during the past century and a half and the increasing variety of industrial products made available by modern techniques have multiplied the uses of land and increased its value.

Industrialization has shifted population from rural to urban areas. Whereas in 1880, 28.6 per cent of the population of continental United States lived in towns and cities of over 2,500, in 1940, 56.5 per cent lived in such communities. On the other hand, the population in incorporated places of less than 2,500 and of rural areas decreased from 71.4 per cent of our total population to 43.5 per cent during the same period. This population shift was stimulated not only by rapid industrialization and increasing mechanization of agriculture, but also by remarkable improvement in transportation, bringing requisite food supplies to cities and carrying manufactured products to all parts of the world.

The growth of American cities has been less rapid since the First World War than in former periods of our history. Fifteen cities of more than 50,000 people each actually lost population between 1920 and 1940. The trend toward suburbanization has been particularly pronounced for those cities with populations between a quarter of a million and a million each. Although that long-run trend was reversed in certain defense areas during the Second World War, this short-run tendency must be viewed as a wartime aberration. It is likely that the prewar movement of population toward suburbanization and decentralization of industry will continue in the postwar era. The significance of this retardation in city growth will be discussed later in this chapter in connection with the problem of urban land valuation.

19–7. Competition for Uses of Urban Land. The many and diverse uses of urban land compete with each other. Under conditions of competition the available supply of land will tend to be apportioned in accordance with its most profitable use. This is reflected in the competitive prices people are willing to pay for present and prospective uses of urban locations. If,

for example, a certain site is more valuable for a mercantile establishment than for a dwelling, the dwelling will sooner or later make way for the store. If another site is more valuable for a hotel than for a bank, the bank will eventually be replaced by a hotel.

The economic principles involved in thus allocating urban sites to their most profitable use or uses are those of opportunity costs and substitution at the margins of transference. Under conditions of competitive demand, the maximum usefulness of an urban site for one purpose tends to coincide with its minimum usefulness for the next higher purpose. Through the operation of the price mechanism, the market supply of land in an urban area thus tends to be adjusted to its most profitable uses.

The transfer of land from one use to another at the margins of transference actually takes place only within broad limits and only over longer periods of time. In the long run, however, the tendency to put urban sites to their most profitable use prevails. Even the famous old Waldorf-Astoria Hotel in New York City eventually yielded its location to the 102-story Empire State Building.

19–8. Rental Value of Urban Land. Urban land, like any other economic good, is valuable because of its utility and scarcity. It derives its utility primarily from its location with reference to the manifold activities that enter into the composite life of a modern town or city. In selecting urban locations for different purposes, people are influenced by a variety of factors. The manufacturer endeavors to establish his plant where he has ready access to power resources, labor supply, raw materials, and markets for intermediary and finished products. The homeowner is influenced in his choice by nearness to place of employment and transportation facilities as well as by proximity to educational and social opportunities. The retail merchant strives to establish his place of business along the main arteries of shopping traffic. Thus a great variety of influences affects the desirability of urban sites for different uses.

Although there may be many alternative demands competing for the use of specific urban sites, their market supply is scarce. Moreover, because of immobility of land the market supply cannot be increased in specific locations by drawing on the physical supply somewhere else. As previously indicated, the owners of such locations are in a monopolistic position; they can raise the prices of their land to equal those of the highest bidders among prospective users. Consequently, the prices paid for the use of urban sites, under the influence of competitive demand, will tend to reflect their most profitable uses.

If the prices of urban locations thus established are paid recurringly to their owners at regular intervals, these payments express the earning power of those sites. The earning power of urban sites is either realized or realizable, depending upon the wishes of the owners as to the uses of their

property. An owner may withhold or limit the present use of a favorably located tract of land in the business center of a city in order to have it available for a higher or more profitable use at a later date, when anticipated population growth and economic development may increase the demand for it. In other words, he may be holding it until it has "ripened" to the higher use and the greater value.

The earning power or net income of a tract of land, in turn, is the measure of the economic rent of that land. In pecuniary terms, maximum economic rent is the measure of the net money value of the products or services obtained from the most economic utilization of a tract of land. The net money value, moreover, is obtained by subtracting from gross income costs of labor and capital necessary to such land utilization.

19–9. Valuation of Urban Land. *a. Capitalizing Constant Rent.* The capital value of urban land, as of land in general, is determined by capitalizing its expected net income, or economic rent, at an assumed rate of interest. By capitalization is meant the process of finding the present combined values of all the anticipated recurring future incomes. Such a capitalization process is based on several alternative assumptions. It assumes either a constantly recurring net income from land at regular intervals, an increasing income, or a decreasing income. Moreover, it assumes a certain period of time over which these returns may be anticipated, and a definite rate of capitalization.

Where a constant return is assumed from year to year, economic rent is analogous to a regular annuity. Thus if the rate on minimum risk investments is 2½ per cent, and the perpetual earning power of a tract of land is assumed to be $100 per year, the capital value of this annuity is equal to $4,000.[1] In other words, $4,000 invested in a minimum risk investment would yield its owner an annual income of $100 at 2½ per cent.

b. Evaluating Future Growth. An increasing net income from land may be anticipated over a period of years, instead of a constant rate of return. Consequently, if a larger net income is expected to be realized from an urban site in the future as it "ripens" into higher uses, its present market value will tend to rise above that which would obtain if no such prospect existed. The current return on investments in such sites will tend to be less than the return on other sound investments without similar possibility of appreciation. Urban tracts frequently have sold at prices returning only 2 per cent, or even less, on the current market prices of these lands. Obviously the values of such tracts reflected not merely assumed regularly recurring net incomes, but also prospective increasing incomes or resale

[1] $V = \frac{a}{r}$, where V = market value, a = anticipated annual regularly recurring income, and r = assumed interest rate.

values. Moreover, declining long-term interest rates likewise tend to increase the market values of regularly recurring net incomes. Thus, even in the face of no anticipated increase of the rental values of urban sites, their market values would tend to rise in the face of declining long-term interest rates.

In the past, the anticipated continual increases in urban population and prosperity have been important factors in urban land valuation. With growth of population and income, increased demand for urban sites was assumed, which, in turn, would increase their earning power. Consequently prospective larger net incomes from land were capitalized into increased market values at practically constant interest rates.[1]

c. Discounting Future Decentralization. Since the First World War in particular, the growth of many American cities has been distinctly retarded, not only because of immigration restriction but also because of the trend toward suburbanization of population and decentralization of industry. In consequence, it is more than likely that the market values of many urban locations will be permanently adjusted to a level of net rents, indicating more modest prospects. Instead of anticipated higher incomes serving as the basis for urban land valuation, constant or actually decreasing future net incomes may become the basis for such valuation. Only the lower long-term interest rates would counteract a prospective declining market value of urban land. These observations have a direct bearing on future taxable real-estate values as the primary source of local tax revenue.

19–10. Taxation of Rental Values and Capital Values of Urban Land. Much confusion in connection with the proposal for land-value taxation has arisen because of the failure to distinguish between rental value and capital value of land. The former pertains to the recurring income from the use of land, while the latter expresses the market value of land, reflecting the capitalization of these anticipated recurring incomes.

[1] When an absolute increase in annual net rent over current rent is expected, the capitalization formula becomes $V = \frac{a}{r} + \frac{i}{r^2}$, where i = the anticipated (or speculative) average annual increase in net rent, above the current rent. Thus, if an urban site yielded a net rent currently of $100, and its rental income were expected to increase annually around $2.50, the market value of this site would tend to rise to $8,000, assuming a 2½ per cent rate of interest.

$$V = \frac{a}{r} = \frac{100}{0.025} = \$4{,}000 \quad \text{(regularly recurring annual income)}$$

but

$$V = \frac{a}{r} + \frac{i}{r^2} = \frac{100}{0.025} + \frac{2.5}{0.000625} = \$4{,}000 + \$4{,}000 = \$8{,}000$$

(regularly recurring plus prospective increase in income)

A tax rate imposed on the rental or income value of land would tend to decrease the net income to the owner correspondingly. If a 100 per cent tax or a 50 per cent tax were imposed on the income value of a tract of land as this income is obtained, that land would obviously yield no income or half income respectively to its owner.

On the other hand, a rate of taxation on the market or capital value of land is paradoxical. Let us assume that a tract of land is yielding its owner $1,000 a year in rent, which earning power is the measure of the most profitable utilization of that site. If this earning power were capitalized at 2½ per cent, the capital value of the site would be $40,000. In the absence of any anticipated further urban growth, this capital value would tend to equal the market value. If now a 2½ per cent tax were to be levied on this market value in order to tax away the full currently yielded economic rent, the market value of that land to its owner would be destroyed. In consequence, there would be no market value to tax. If there were no market value of the land because of this tax, it would seem paradoxical to continue it by levying against a nonexistent market value. Thus a tax rate levied on the market or capital value of land, with a view to taxing away this value, is self-contradictory, since it tends to destroy the very base on which that tax is imposed.

Land-value taxation, therefore, to be economically sound, must be based on realizable current-income, rather than on market or capital, values. If such income values were made the basis of land-value taxes, they would tend to be levied more in accordance with ability to pay than are our present property taxes, which, as shown in the last chapter, are levied on capital or market value.

19–11. Urban Housing Problem. One of the major uses of urban land is to provide suitable habitation. Prior to the First World War, housing in the United States was left almost entirely to private enterprise and individual initiative. Cooperative financial and credit organizations, such as building and loan associations, had been instrumental in aiding individuals in the purchase of their homes. But even these agencies were private rather than public.

a. Inadequate Housing. Under the reign of *laissez faire* in American housing, many decadent or blighted areas have been allowed to develop in our cities. Sheltering the lower income groups, they became a disgrace to our advanced civilization. Indeed, adequate housing to shelter these lower income classes has rarely been provided on private initiative in American cities.

Although it is difficult to define specifically what constitutes adequate housing for an American family, at least certain minimum requirements, such as running water, toilet facilities, and a bathroom, should be available to every family in an urban home or tenement. Without these bare necessities any shelter may be regarded as substandard. Yet the Real

Property Inventory, made under the auspices of the United States Department of Commerce in 1934, showed that in 64 American cities, of 2,633,135 dwellings investigated, 24.5 per cent had no bathtubs or showers and 17.3 per cent had no private indoor toilets.

b. Insufficient Housing. During both world wars, the construction of urban dwellings declined significantly. This decline was attributable, in part, to fear of the development of "ghost towns" in various defense areas in which wartime housing demand increased abnormally. This wartime demand was met largely by constructing temporary housing and developing trailer camps, as well as by converting existing family accommodations into multifamily units. Furthermore, while the urgent requirements to finance the war decreased the capital available for housing construction, labor was being diverted either into military services or to wartime industry. To carry on its wartime program, the Federal government, in both world wars, established priority on all building materials.

In consequence, urban housing by private agencies was neglected during the war periods. In 1917–1918, residential construction in 131 American cities declined to less than one-half of the average for 1913. In 1922, the Secretary of Commerce estimated a total housing shortage in the United States of 12 million dwellings. A similarly acute housing shortage existed in most communities of the country at the close of the Second World War. A million families were said to be living "doubled" up with others. Many a returning veteran, entering postponed marriage, was unable to find a dwelling in which to establish his household.

Again in 1945, as in 1922, it was officially estimated that 12 million housing units would be needed in the first postwar decade in order to meet existing housing needs of the country, while anticipated new construction for 1946 amounted to only 450,000 family units. To help meet this critical housing shortage of 1946, 100,000 emergency units, in the form of barracks and dormitories, were made available by the Army and Navy, while wartime prefabricated temporary dwelling units were moved to areas of acute shortage. But these measures were merely temporary devices and offered no permanent solution to the housing problem of American cities.

Rapid expansion of private urban and suburban residential construction during the twenties had practically solved the housing problem for the upper and middle income classes, but it reappeared because of decreased construction in the thirties and almost complete cessation of home building during the Second World War. The problem of providing adequate housing for families of low income, however, was chronic and continuous, rather than intermittent and acute. Its continued existence before, during and after the Second World War demanded governmental action in the form of a low-rent public-housing program, first inaugurated in 1937 under the Federal Housing Act, summarized on page 380.

c. Home Ownership versus Tenancy. Adequate housing for the people is a major concern of any democracy. It is related to the issue of home ownership versus tenancy, which, in turn, raises the question of the mobility of labor and labor migration.

Wide home ownership injects an element of rigidity into our economic structure that militates against the requisite shifts in population, necessitated by changes in industrial activity and localization of industry. This rigidity is accentuated particularly during periods of business depression. It thus is intimately related to the problem of maintaining high levels of productive employment in our postwar economy.

On the other hand, excessive tenancy, with incidental insecurity of home tenure and the absence of a sense of home ownership, which might make for greater labor mobility and so facilitate stabilization of employment, may tend to undermine the very foundations of private property, on which our established economic order rests.

> It is doubtful whether democracy is possible where tenants overwhelmingly outnumber home owners. For democracy is not a privilege; it is a responsibility, and human nature rarely volunteers to shelter responsibility, but has to be driven by the whip of necessity. The need to protect and guard the home is the whip that has proved, beyond all others, efficacious in driving men to discharge the duties of self-government.[1]

These broader phases of the problem of housing the population of a country such as ours, connected as they are with either home ownership or tenancy, can only be suggested here. But they deserve the serious consideration of all those who are concerned with the continued welfare of the nation as a whole.

19–12. Slum Clearance. *a. Nature and Causes of Slums.* One phase of the problem of providing adequate housing for the lower income classes in American cities is that of slum clearance. Slums have been facetiously defined as "inhabited uninhabitable habitations." They are overcrowded derelict urban areas that have developed from many causes.

The absence of adequate city planning, zoning, and building regulations in many American cities has been an important contributing factor to the development of decadent urban districts. Again, both the foreign-born and Negro population in American cities frequently have received inadequate wages to provide them with decent housing, except, perhaps, during war boom periods. Ignorance also has contributed to the development of decadent urban areas.

Moreover, the rapid expansion of the demand for shelter in growing American cities, particularly as a result of heavy immigration prior to the

[1] LAMONT, ROBERT P., in Foreword to "Home Ownership, Income, and Types of Dwellings," published by the President's Conference on Home Building and Home Ownership, Washington, D.C., 1932.

First World War, made possible the exaction of profitable rentals for dilapidated dwellings. Although the rent per person or per family in decadent areas may be fairly low, overcrowding has often made the rent per room or per dwelling sufficiently high to yield a profit to the owner without his incurring the necessary cost to make the dwelling suitable for decent living.

All of these factors have combined in creating and continuing unfit residential districts in American cities. Unemployment during the depression of the thirties further emphasized the overcrowding of population in such areas. Lack of adequate purchasing power perpetuated lack of adequate housing, and a low demand for building construction failed to stimulate reemployment during the thirties.

b. Implications of Slum Clearance. The acuteness of the situation focused public attention on the appalling conditions prevailing in many urban districts, particularly during the period of mass unemployment during the thirties. Slum clearance, with Federal aid, was therefore widely advocated. It was held that this would not merely provide employment but would also serve to revive the building industries. Moreover, the social and economic benefits of cleaning up decadent areas were stressed.

Slum clearance has been broadly interpreted to mean the demolition of houses unfit for habitation, the rebuilding or reconditioning of other dwellings, and the improvement of the physical environment in areas which were regarded as former slum districts.

But decadent residential areas in American cities have frequently developed near the centers of industrial and commercial sections, where over a period of time land values were expected to rise as land was transferred from a lower to a higher economic use, as, for example, from residential to commercial utilization. Owners of such land placed a relatively high value on it, reflecting the anticipated higher net incomes in the future, as the land "ripened" to its higher uses. Such high-valued land has been unsuited for adequate housing for the lower income groups, for it had to be overdeveloped for residential purposes to "make it pay."

Modern housing authorities view suitable housing not merely from the angle of shelter, but also from the angle of adequate recreational and playground facilities; and these cannot be provided for the lower income groups unless land is reasonably cheap. Land priced too high for proper housing has been a major reason for the crowding of population into small tenements in many American cities.

19-13. Adequate Low-rent Urban Housing. Another problem of urban land utilization intimately related to that of slum clearance is the provision of decent homes for the lower income groups at modest rentals. Some critics of private enterprise have contended that private capital and individual enterprise cannot profitably provide such adequate housing facil-

ities for the lower income classes, who are unable to pay rentals sufficient to cover building and maintenance costs. Hence the agitation for governmental assistance in the construction of low-rent houses. Many arguments have been advanced either for or against an extensive governmental program of low-rent housing.

a. Arguments for Governmental Housing Aid. Proponents of such a program maintain that private enterprise cannot profitably provide decent shelter for the lower income classes. If it could, decadent urban areas would have been allowed neither to come into existence nor to continue in such conditions.

Furthermore, it is argued that it is the responsibility of society to provide for the less fortunate, whose income, even under normal conditions, is inadequate to furnish them with decent shelter. Construction of relatively moderate-priced urban dwellings for families with incomes from $2,000 to $3,000 by private agencies is, in reality, not getting at the root of the low-rent housing problem. Even in 1941, according to surveys of the Bureau of Labor Statistics, 60 per cent of the families of 2 or more persons in the United States had an annual family income of $2,000 and under. Such families, whether living in urban or rural areas, constitute the lower income groups for whom, it is maintained, private enterprise cannot profitably provide adequate low-rent housing.

Again, numerous studies in recent years have demonstrated that the costs of maintaining decadent areas, inhabited by the lower wage-earning classes in cities, vastly exceed the tax revenues derived from levying against property values in such areas. Consequently, it has been argued that other taxpayers are actually contributing to maintain unhealthy and indecent living conditions. It would seem more logical to use a portion of that tax revenue to subsidize the construction of low-rent dwellings and to eliminate slum areas from American cities. Furthermore, public housing construction has come to be viewed as an important field of public enterprise, which may be expanded in periods of business depression and contracted in periods of business boom, and thus help to stabilize employment in our postwar economy. Lastly, it is maintained that governments can borrow funds at lower interest rates than can private agencies. Consequently, they can finance the construction of houses at lower costs than can private builders, and so reduce their rentals to prospective tenants. This argument and others in support of public ownership and operation will reappear in a subsequent discussion of public utilities.

b. Arguments against Governmental Housing Aid. On the other hand, opponents of governmentally constructed or subsidized low-rent housing projects present many salient arguments to the contrary. It is maintained that the use of public funds to subsidize housing construction and to recondition dwellings, in reality, is not providing low-rent housing at all, but

merely housing the lower income groups, in part, at the expense of the taxpayer. It is therefore an uneconomical redistribution of income. Furthermore, it is alleged that as a result of the increase in housing accommodations, privately owned dwellings will be depressed in rental and market values. Again, it is argued that governmentally built houses will be exempt from local taxes, and thus add to the burden of taxation on the remainder of the community to provide police and fire protection, sanitation, education, etc., for those living in publicly financed houses. It is also felt by many persons that governmentally subsidized housing will increase bureaucracy. Moreover, it is maintained that publicly subsidized housing for the lower classes savors of socialism and is contrary to the principles of individual enterprise. The question of constitutionality has also been raised by the opponents of public low-rent housing. Lastly, it is often maintained that many persons living in decadent areas and under insanitary conditions would not want better dwellings even if these were provided for them. Where this is the case, however, it must be ascribed primarily to ignorance, which is not an inherent attribute of a people, and which is not limited to any particular income group.

c. Failure of Private Enterprise to Provide Adequate Low-rent Housing. Admitting a certain degree of validity to the arguments both for and against the use of public funds to promote low-rent housing, the fact remains that private enterprise has failed to provide decent housing at low rentals to tenants in American cities. It is doubtful that it is possible to build suitable family accommodations in the larger American cities by private builders to rent for $20 per month or less, at the costs of new construction prevailing at the close of the Second World War. Yet in 1940, more than 4.6 million, or 36 per cent, of rented urban dwelling units in the United States were renting for less than $20 per month.[1]

If the real income of low-paid wage earners were to be considerably increased, it might be possible for these groups to pay a sufficiently high rent to assure decent dwellings, provided by private enterprise. But higher money wages alone give no assurance of adequate housing for the lower income classes. Only if labor productivity were increased and the total income stream available for wage distribution were enlarged would individual workers be able to pay for better housing. It is dubious whether an increase in wages for those at the bottom of the wage scale could be realized that would be sufficient to provide them with adequate housing without governmental aid. Although money wages in the lower wage-earning classes showed a substantial increase during the Second World War, costs of new housing construction likewise increased. If it had not been for rent control, extended into the postwar period, rents would probably have risen as rapidly as money wages, and perhaps even more, in view

[1] *Statistical Abstract* of the United States, 1944–1945, p. 915.

of the actual shortage of housing units to accommodate families in nearly all income brackets.

Private enterprise has not solved the problem of adequate housing for lower income families. American cities are thus apparently confronted with the alternative either of continuing the conditions that make for overcrowding and the development of slum areas, or of using publicly provided funds (Federal, state, or local) to aid in providing reasonably low-rent housing for the lower income groups and to clear slum areas. While the objective is clear, the method or methods of realizing it is a major controversial issue.

In the face of possibly higher prices for building materials in the postwar period, it is very questionable whether technical progress in private housing construction will make for cheaper housing in the future. Only if costs of building construction were to be materially reduced, and money wages in the construction industry held down, might private competitive building enterprise be relied on to provide low-rent dwellings for the lower income groups. Lowering the tariffs on many items entering into housing construction, as well as reducing transportation rates, would help to bring down building costs. Any proposals along these lines involve the protective-tariff issue and the problem of freight rate making.

19–14. Postwar Housing Program. Late in 1945 President Truman laid down a three-point program designed to expedite low-cost housing construction and to keep the prices of existing housing from advancing further. The program called for (1) the immediate release of surplus housing facilities and material held by the government, (2) priorities for lower priced dwelling construction, and (3) legislative sales-price ceilings on both old and new dwellings. A Federal Housing Expediter was appointed by the President to carry out the program. But private enterprise promptly criticized the program by arguing that existing price ceilings prohibited the revival of private housing construction, in the face of desperate shortages both of essential building materials and of skilled labor in the building industry.

In spite of governmental efforts, the acute housing shortage in many American cities continued in postwar years. It was accentuated by the return of millions of service men to civilian life, and their desire to establish, belatedly, their own households.

19–15. Federal Housing Assistance. *a. Social Responsibility.* In the light of both prewar and postwar realities, it would appear that low-rent housing will have to be achieved, in whole or in part, at public expense. This action may be regarded as a necessary social cost, similar to that of public safety, public health, and public education.

Such assistance may be provided by either Federal, state, or local governments. In the final analysis, any public subsidy for housing construc-

tion must come out of taxes. It represents a social cost, incurred to promote the general welfare.

If the solution of the problem were to be left solely to each local community, it is doubtful whether very much would be accomplished. Variations in taxing ability and borrowing capacity in widely separated cities, divergent political and economic interests, and different degrees of social responsibility assumed by the communities all militate against attaining uniform public action. It would, therefore, appear to be more logical to view the problem of proper and adequate housing of the lower income classes as a national issue, requiring Federal assistance for its solution.

b. Forms. Public aid may take on a variety of forms. It may be in the nature of an outright Federal subsidy or grant to either a local government or a private limited-dividend housing corporation.

Moreover, it may take the form of direct subsidies to private builders, under the stipulation that rents must be within desired limits. Federal subsidies in one form or another to private agencies, to promote socially desirable objectives, are nothing new in American governmental policy. Witness, for example, our traditional protective-tariff policy, and the Merchant Marine Act of 1936, helping special interests, and also the Soil Conservation and Domestic Allotment Act of 1936, providing Federal aid to farmers, in return for soil conservation. In essence, all governmental subsidies effect a redistribution of the national income. They are usually acceptable to those who benefit from such redistribution, and objectionable to those who reap no benefits proportionate to the costs incurred.

Federal aid may also consist of governmental loans at relatively low rates of interest to local housing authorities. If public loans were granted at several per cent below the interest on private mortgage loans, a substantial reduction in carrying charges could be effected, and rents reduced accordingly. It has been variously estimated that a 1 per cent reduction in the annual interest rate on capital funds for housing construction makes possible a decrease in monthly rentals between 80 cents and $1 per room.

c. Federal Guarantees of Private Mortgages. It is doubtful that governmental guaranteeing of private mortgage loans, in order to minimize risks to investors in real-estate mortgages, would attract an adequate supply of capital funds at sufficiently low interest rates to make possible low-rent housing construction.

The National Housing Act of 1934 provided for the establishment of a Mutual Mortgage Insurance Fund under the National Housing Administration, to be used to insure first mortgages on residential dwellings for not more than four families. Moreover, it authorized the establishment of National Mortgage Associations, to deal in first mortgages, insured under the act.

But all such Federal guarantees of investments in real-estate mortgages did not attract private capital funds into low-rent building construction at low rates of interest, in amounts sufficient to meet housing needs. It may take years before private investors in real-estate mortgages will become fully reconciled to lower rates of return.

d. Federal Housing Agencies. It was widely believed that the Housing Division of the Federal Emergency Administration of Public Works, created in 1934, would carry out an extensive program of low-rent housing construction throughout the country. But the many obstacles confronting the administration, partly because of lack of a clear-cut governmental housing policy, and partly because of opposition of political and private interests, were such that very little was accomplished by this agency.

In 1937 Congress passed the Federal Housing Act, creating the United States Housing Authority. This authority was empowered to make loans at low rates of interest to local housing authorities, for the purpose of slum clearance and low-cost housing development. Congress appropriated an initial sum of 500 million dollars to be used for such low-cost housing. The act provided, moreover, for Federal subsidies, in the form of either annual contributions or a capital grant to local housing authorities, to keep rents within reach of recipients of small incomes.

e. Centralization of Governmental Housing Functions. The National Housing Agency was created by executive order in 1942 to consolidate the housing functions and activities of 17 former governmental housing agencies, such as the various Federal Home Loan Financing Corporations, the United States Housing Authority and Wartime Defense Housing Administrations. Its functions included surveying community housing needs, compiling employment and housing data, and, in the light of available information, determining the proportion of housing needs that was essential to the war effort that must be provided through publicly financed housing.

19–16. City Planning. Adequate housing of urban populations and removing of decadent areas are twin phases of the larger problem of efficient urban land utilization. They constitute an integral part of the problem of city planning, which has been receiving increasing attention in recent years.

a. Nature. City planning may be defined as the attempt to exercise well-considered social or public guidance over the development of the physical environment of an urban group of people, thereby increasing the working efficiency, the architectural beauty, and the civic usefulness of their city.

b. Essentials. A comprehensive plan for public guidance in urban land utilization necessitates a careful study of past trends in urban development in various parts of the city, to serve as an indicator of the changing habits of people. It requires also a thorough survey of present usefulness of urban

land, so as to derive maximum benefits for the community from its available land supply. Finally, a land inventory and plan are essential to provide for the future expansion of urban activities.

Land-development projects carried on by private agencies are often stimulated by the quest for immediate personal gain. When once a comprehensive plan for urban development has been adopted, personal interests must be subordinated to community interests, whenever the two conflict.

c. Examples. Even before the outbreak of the Second World War, there were 750 city-planning commissions operating in the United States. During and since the war other communities created planning agencies. This, in itself, is an indication of the growing recognition of the importance of public guidance in urban land utilization, for most of these commissions have been established since the First World War. Viewed as an economic problem, their chief function is to plan and recommend to appropriate governmental authorities the proper utilization of urban land so as to derive the maximum benefits from its use for the community as a whole.

19–17. Public Guidance in Urban Development. A comprehensive city plan should seek to coordinate the manifold activities that, in the aggregate, go to make up the life of a modern city. These activities may be grouped under five specific heads.

a. Economic Aspects. In the first place, there is the economic, or industrial, activity of the community, affecting directly the material well-being of the people. A carefully planned program for the economic growth and development of a city will provide for the proper localization of heavy and light industries, adequate transportation facilities by land, water, and air, easily accessible wholesale and retail business districts, as well as conveniently located financial institutions.

b. Social Aspects and Family Life. Intimately associated with these economic activities are the social activities of a community. The center of social life in American cities is the individual dwelling, or home. New residential construction in 257 comparable cities of the United States between 1925 and 1944 showed an upward trend in one-family dwellings from 45.9 per cent of the total in 1925 to 76.7 per cent in 1944. On the other hand, multifamily dwellings decreased from 36.6 per cent of the total to 11.8 per cent during the same interval.

A well-rounded city plan must take cognizance of the significant changes that urban conditions of living are undergoing. A reapportionment of urban land areas among their many uses will be necessitated by the modification of the social life centering about the family home. Club life, as a phase of the social activities of an urban community, is likewise undergoing changes of profound significance. These changes may be attributed in part to the repeal of prohibition, in part to the ubiquity of the automobile

and the radio, and in part to the development of an attractive type of community life in many of our residential areas. Planning for the complex social life of the American city, and coordinating it with the industrial activities of each community, is one of the most difficult problems confronting any city-planning commission.

c. Educational and Recreational Aspects. In the third place, educational and recreational activities enter into the composite of urban life. Although it has been said that education is a necessity but recreation a luxury, the line of demarcation between these two activities is not as sharply drawn as it was in former years. The systematic training of the body has come to be looked upon as equally important with the formal training of the mind. Hence the recognition of the need for adequate recreation centers and playgrounds, as well as for educational institutions, in modern city plans.

d. Inspirational Aspects. Another integral part of a program for urban development centers about the inspirational life of a community. It is represented not only by places of worship, but also by shrines of art, literature, and music. It is apparent that the line between recreational, educational, and inspirational activities cannot be sharply drawn. Witness, for example, the denominational and parochial schools identified with religious institutions, and the increasing use of museums of art in connection with educational programs.

e. Political Aspects. Lastly, governmental activities of a community must be provided for in a comprehensive city plan. These pertain not merely to the administrative functions of government but also to the development of public institutions to care for specific social needs, such as hospitals, asylums, prisons, and charitable institutions.

The foregoing activities, in the aggregate, make up the life of the modern city. Its smooth and harmonious functioning is contingent upon proper correlation of these activities. In view of the frequent conflicts arising between individual and community interests in connection with city life, public guidance in urban development has become a modern necessity.

Guide Questions on Text

1. Explain the reasons for the existence of land problems.
2. Why has the right to the use of the air attained economic significance?
3. Why is there likely a conflict of interests between public and private utilization of land?
4. Distinguish between the physical and the economic supply of land.
5. How has urban growth affected land utilization?
6. Distinguish between the rental and capital value of land, and show how the two concepts are related.
7. Explain how anticipated growth in urban population has affected the valuation of urban land.

8. Trace clearly the difference between taxing rental values and taxing capital values of urban land.
9. What is meant by the urban housing problem?
10. What factors have contributed to creating the urban housing problem?
11. "Wide home ownership injects an element of rigidity into our economic structure." Explain the consequences of this rigidity.
12. Explain what is meant by slum clearance. Show its broad implications.
13. Which do you think is correct, "Slum dwellers create slums" or "slums create slum dwellers"? Give reasons for your viewpoint.
14. Present the arguments that have been advanced for and against low-rent public housing projects.
15. Account for the failure of private enterprise to provide adequate housing for families of low income.
16. "Public assistance in providing adequate housing for families of low income has taken on a variety of forms." What are they?
17. What is the relationship between adequate urban land utilization and housing?
18. Summarize the requirements of effective urban land-use planning.
19. Explain the various activities that must be coordinated in a comprehensive city plan in order to put urban land to its optimum use.

Topics for Investigation

1. Costs to municipalities to maintain slums.
2. Causes and effects of slum areas.
3. Public guidance in urban land utilization.
4. Public housing as a factor in economic stabilization.
5. Effects of improvements in transportation on urban land values.
6. Taxing urban land into use.

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CHAPTER XX

AGRICULTURAL PROBLEMS

20-1. Status of American Farmers before and during the Second World War. *a. Disparity between Farm and Nonfarm Prices.* During the period between the two world wars much was said and written about the plight of the American farmer. It was commonly attributed to the shrinkage in his buying power because of the low prices he received for his products, relative to the prices he had to pay for nonagricultural products. Early in 1933, farm-commodity prices had dropped to 50 per cent of their level just prior to the First World War, while the prices farmers had to pay for goods they bought remained at or slightly above the 1909 to 1914 average level.

TABLE 14. RATIO OF AVERAGE PRICES RECEIVED BY FARMERS TO AVERAGE PRICES PAID BY THEM *

(Base 1909–1914 = 100)

Year	Ratio	Year	Ratio	Year	Ratio	Year	Ratio
1910	104	1920	105	1930	87	1940	80
1911	94	1921	82	1931	70	1941	94
1912	100	1922	89	1932	61	1942	106
1913	100	1923	93	1933	64	1943	119
1914	101	1924	94	1934	73	1944	115
1915	93	1925	99	1935	86	1945	116
1916	95	1926	94	1936	92	1946	120
1917	117	1927	91	1937	93	1947	120
1918	115	1928	96	1938	78		
1919	105	1929	95	1939	77		

* *The Agricultural Situation,* U. S. Department of Agriculture, Dec., 1940, p. 24, Oct. 1945, p. 4, and Apr., 1947, p. 12.

But even before the depression of the thirties, for a number of years, there had been a considerable disparity between the prices the farmers received and those they had to pay, in comparison with the situation preceding the First World War. This disparity is indicated in Table 14.

This table shows the long and often heavy disadvantage in prices of farm products under which the American farmer labored from 1921 to 1941, in contrast with the brief price advantage he enjoyed between 1917 and 1920, and again between 1942 and 1948. The disparity, although tending to decrease under the Agricultural Adjustment Act between 1933 and 1936, nevertheless still existed when this act was declared unconstitutional early in 1936. By the fall of 1936, the price disparity had almost disappeared only to become very pronounced again from 1938 to 1940. During the Second World War, the abnormal increase in demand for farm products rapidly drove farm prices upward, so that many American farmers once more enjoyed a period of prosperity, even as they had previously during the First World War.

b. Variations in Farming Income Relative to Total National Income. In the interwar period, the share of the national income derived from farming showed a significant decline, particularly during the thirties (see Table 15 on page 386). This served as another indicator of the peacetime plight of the American farmer. Even before the First World War, farmers received a share of the national income that was not in proportion to the income received by other groups of our population. After 1920, however, their share of the national income became progressively smaller down to 1933. This shrinkage was particularly pronounced in 1932, when farm income was less than one-half of what it had been in 1910. For the period between 1935 and 1939, the average per capita income of our farming population was likewise less than one-half the average of all other groups.

Table 15 on page 386 shows the disparity in the ratio between net farming income and total national income between 1929 and 1945. The plight of American farmers during the thirties is clearly revealed therein, for it indicates the disproportionate shrinkages in farm incomes during the depression years.

With the outbreak of the Second World War, the picture of American agriculture brightened; it continued bright during the dark years of the war. The index of prices received by farmers was 94 per cent higher in 1944 than in 1940, while cash income from farm marketings was 137 per cent greater and net farm income about 160 per cent above the prewar level.

Even during the Second World War, however, the proportionate share of the national income of the United States received by farmers was not very much greater than it had been in 1929, although it was considerably higher than in 1932 (see Table 15). While the total national income in 1945 was 93 per cent greater than in 1929, the net income from farming was 107 per cent above the 1929 level. The higher incomes of 1945, as compared with 1929, received both by our farming population and by our nonfarming population indicated not merely increased money incomes but

also real incomes, since the 1945 cost-of-living index was only about 5 per cent above the 1929 figure. The American farmers as a class were thus enjoying somewhat greater real prosperity during the Second World War than the nonfarming population. If converted to a per capita basis, this

TABLE 15. TREND IN NET FARMING INCOME RELATIVE TO TOTAL NATIONAL INCOME,* 1929–1945

(Dollar items in millions of dollars)

Year	Net income from farming †	Total national income	Farming income as per cent of total national income, per cent
1929	$ 6,745	$ 83,326	8.09
1930	5,114	68,858	7.43
1931	3,482	54,479	6.39
1932	2,285	39,963	5.72
1933	2,881	42,322	6.81
1934	3,134	49,455	6.34
1935	4,554	55,719	8.17
1936	5,111	64,924	7.87
1937	5,779	71,513	8.08
1938	4,629	64,200	7.21
1939	4,557	70,829	6.43
1940	4,711	77,514	6.07
1941	7,015	96,857	7.24
1942	10,608	122,232	8.68
1943	13,258	149,392	8.87
1944	13,223	160,653	8.23
1945	13,969	161,000	8.68

* Compiled from *Statistical Abstract* of the U. S., 1944–1945, pp. 403 and 647. Net farming income data since 1940 revised, taken from "Farm Income Situation," Bureau of Agricultural Economics, U. S. Department of Agriculture, June, 1946, p. 27.

† Excluding government subsidy payments since 1933.

wartime advantage of American farmers would appear still more favorable, in view of the relative decline in farming population since 1929.

The growing wartime financial well-being of American farmers as a class was reflected also in the growth of time and demand deposits of farmers since 1940. Total farmer-owned bank deposits (demand and time) in the United States more than tripled, rising from 2.9 billion dollars in 1940 to 10.1 billion dollars in 1946.[1]

[1] *Federal Reserve Bulletin*, Sept., 1946, p. 980.

But even wartime prosperity among farmers did not remove poverty from some agricultural areas in the United States. While in seven states average cash income from sale of farm products was $5,000 per farm in 1942, it was less than $900 per farm in three other states. Many families living on farms produced only small commercial incomes from what are called cash crops. Unless they could supplement their money income by other work, these farmers continued to exist at a very low income level, even during the war boom.[1]

c. Trend in Farm Indebtedness. During the thirties, aggregate farm mortgage debts declined 32 per cent. They had totaled 9.6 billion dollars on Jan. 1, 1930, while by Jan. 1, 1940, they had been reduced to slightly under 6.6 billion dollars. Farm mortgage interest payments likewise revealed a significant downward trend, particularly since 1933. This decline in farm mortgage debt and interest payments in the decade before the Second World War was due largely to foreclosures and to mortgage refinance at lower interest rates with Federal aid.

The downward trend in farm mortgage debts and interest payments continued during the Second World War. Aggregate mortgage indebtedness on American farms dropped 23 per cent between January, 1940, and January, 1946, or from 6.6 billion to 5.1 billion dollars. Aggregate interest payments on farm mortgages were 14 per cent less in 1944 than they had been in 1940. Increasing farm real-estate purchases during the Second World War were made for cash, and not so extensively as during the First World War with the aid of loan funds. While the average value of farms in the United States by July, 1946, had risen to a level 77 per cent above the 1935 to 1939 average—which was only about 14 per cent below the 1920 farm real-estate inflation peak—farmers in general were purchasing new farms with their own cash. They were not incurring such heavy mortgage obligations as they had done during the First World War. Fifty-five per cent of all farm real-estate sales recorded in counties surveyed by the Bureau of Agricultural Economics[2] during the first quarter of 1946 were entirely for cash, compared with 56 per cent for the corresponding period in 1945. Average down payments in farm purchases involving mortgages, moreover, were upward of 42 per cent in 1946, as compared with only 33 per cent in 1942.

Although farm mortgage indebtedness and interest payments on farm mortgages since 1933 have declined, this decrease was more than offset by increased taxes and higher rents. Combined taxes, interest, and rents paid by farmers in 1943 were 54 per cent larger than they had been in 1933. A pronounced shrinkage in postwar farm incomes would thus again ac-

[1] Agricultural Adjustment and Income, *Postwar Economic Studies*, No. 2, p. 6, Board of Governors of the Federal Reserve System, Washington, D. C., 1945.

[2] Press Release of Aug., 1946.

centuate the burden of many rigid costs confronting farmers, and the former unfortunate plight of our rural population might easily be repeated. Another contributing factor would be the relatively inelastic supply of farm labor, caused by the lack of alternative employment opportunities due to occupational immobility.

d. Changes in Dietary Habits. Changes in habits of food consumption, primarily as to quality and variety, both at home and abroad, have also affected the status of American farmers. Far-reaching changes in dietary habits have taken place in the United States, particularly since the First World War. The per capita consumption of wheat flour and of corn meal in the United States has declined, while sugar consumption has increased materially. Although the people of the United States comprise only about 6.5 per cent of the world's population, they consume about one-fourth of the entire world supply of sugar. Since wheat is chiefly a domestic product, while sugar is largely imported, such changes in dietary habits have a significant effect upon the respective crop acreage needed to meet domestic requirements for food.

Furthermore, the increasing displacement of horses and mules by mechanical equipment on American farms has materially reduced the demand for such animals. The number of farm horses and mules declined by 14 million between 1910 and 1940. In consequence, some 50 million acres of farm land formerly used for feed and fodder production have been released for other agricultural uses.

e. Prewar Decline in Exports of Farm Products. Another important contributing factor to the agricultural distress of the thirties was the shrinkage in peacetime export markets for American farm products. While from 1924 to 1929 our average annual exports of 12 major farm crops (including feed converted into pork and lard) required 57 million acres of cropland, only 30 million acres were needed annually to meet export requirements in the 1935 to 1939 period. This is equivalent to a decline in the demand for the products of about 175,000 American farms, with a crop acreage of 155 acres each. The volume of exports of farm products in the thirties was 40 per cent below the level that had prevailed during the more prosperous twenties.

Foreign demand for our agricultural products again expanded rapidly during the Second World War, as it had previously during the First World War. By 1943 the export volume of farm products, including lend-lease shipments, had risen 74 per cent above the average annual level of the prosperous late twenties. Moreover, at the close of the Second World War, export demand for foodstuffs for relief purposes continued at a high level. But this was an abnormal and temporary situation. With the restoration of agricultural production in war-torn countries, their demand for American farm products will diminish.

f. Further Factors Affecting the Economic Status of Agriculture. The composite demand for most agricultural products is relatively inelastic in comparison with that of many industrial products. A substantial decline in market prices of farm products does not greatly increase their consumption. Nor should we overlook the highly competitive nature of agriculture, in contrast with varying degrees of monopoly and monopolistic competition prevailing in many industrial branches. Again, the possibility of exercising human control over the volume of production, once the crops have been planted, is limited, since weather conditions play a significant part in determining the size of crops. In industrial production, on the other hand, forward orders can be made an important factor in production control.

Finally, markets for our major farm crops, such as wheat and cotton, are world-wide in scope; hence, protective tariffs are rather ineffective in raising domestic prices of these products. American farmers are, in essence, producing for world markets rather than merely for domestic markets; therefore they are not "subsidized" by protective tariffs, as are many protected industries.

All of the foregoing observations would seem to indicate that with a return to a peacetime economy, we may again be faced with agricultural problems arising out of disproportionate shrinkages in farm prices and farm incomes below the levels created by the abnormal stimulus of the Second World War. The disrupting influences of the war, the distortion of markets and prices, and the artificial stimulation given to agricultural income during the war, accentuate the magnitude of the farm problems that confront our postwar economy.

20–2. Farm-land Settlement Policy of the United States. In order to understand fully the reasons for the difficulties that have faced, and will very likely again be facing, American farmers in our peacetime economy, it is necessary to review briefly the historical land policy of the United States. Many of the problems confronting American agriculture may be said to have their roots in the land-settlement program of the Federal and state governments dating back to the first half of the last century.

a. Disposition of Public Lands. In its early efforts to establish a national land policy, the Federal government was confronted with the alternative either of giving away land to settlers or of selling it to them. Opposition to the sale of public lands was expressed not only by prospective settlers in the West but also by established industrialists in the East. Manufacturers feared that the sale of public lands to settlers would tend to retard the opening of the West, which they regarded as an important future home market for their products, and that the revenues derived from land sales might break down the fiscal argument for our tariff system, which afforded protection to their infant industries against foreign competition. If

public expenditures could be met with proceeds from the sale of public lands, there would not be such a great financial need to levy duties on imported articles. There was opposition to the sale of public lands from eastern manufacturers also on the ground that a retardation of immigration, by not offering immigrants free land, would check the rapid increase in the supply of cheap labor into this country from abroad and thus force up factory wages and diminish industrial profits.

Agitation for free lands for settlers was crystallized in 1848 in the formation of the Free Soil party. The party platform of 1852 propounded the doctrine that "all men have a natural right to a portion of the soil and that as the use of the soil is indispensable to life, the right of all men to the soil is as sacred as their right to life itself."[1]

b. Homestead Act of 1862. After years of heated controversy and bitter debate in Congress, the Homestead Bill of 1862 was finally enacted into law. Under the provisions of this law, a settler could acquire 160 acres of land, free from all costs other than a small fee for filing his claim. Permanency of settlement was assured by requiring 5 years' residence on the homestead before granting final title to the settler. By 1944, title to approximately 285 million acres of land had been given to settlers out of the public domain.

c. Further Public Aid to Land Settlement. Many states, moreover, encouraged rapid land settlement by establishing immigration departments to advertise land opportunities and to point out colonization advantages to prospective settlers. Some states have given financial assistance to irrigation districts, while the Federal government has developed even more comprehensive reclamation projects. All these activities encouraged further rapid agricultural land settlement.

d. Railroad Building. Railroad building during the second half of the last century went hand in hand with agricultural land settlement. Liberal grants of lands by the Federal government from the public domain served as an added incentive to private enterprise to expand the network of railroads over the country.[2] As will be explained in a later chapter on transportation, a total of 142,500,000 acres of public lands, an area approximately equal to 83 per cent the size of Texas, was granted by the Federal government for railroads, wagon roads, and canal and river improvements since 1850. Much of this physical supply of land, which had formerly been worthless because of its inaccessibility, was thus added to the available market supply, when transportation facilities were developed.

e. Results of Liberal Land Policy. The liberal land policy pursued by the Federal government during the past century attracted ever larger numbers of foreign immigrants to our shores. In consequence of the westward surge of our population, the frontier disappeared.

[1] Quoted by B. H. Hibbard, "A History of the Public Land Policies," p. 357.

[2] Discussed in Chap. XXV.

Until the advent of the twentieth century, thousands of new farm units were created annually out of the public domain. For many decades before the end of the nineteenth century, the rate of increase in the number of farms was even more rapid that that of our total urban and rural population.

The present results of our past land-settlement activities are reflected in the large number of individual competitive farm units still in the United States. In 1940, for example, there were 6,096,799 farms in this country, with an average area of about 174 acres each.

f. Quantitative Equality with Qualitative Differences in Land. Land units allotted to settlers were uniform in quantity but not in quality. The standard area was the quarter section of 160 acres. Some of these quarter sections were insufficient to support settlers and their families, while others, possessing greater fertility of the soil, made it possible to produce a marketable surplus over subsistence requirements with the same amount of labor.

Thus, quantitative equality in the distribution of public lands really resulted in the unequal distribution of the products of the soil among its tillers. Much of the resultant hardship to certain groups of settlers might have been averted had a careful program of soil analysis and land classification preceded land distribution by the Federal government. If public lands had been allotted equally according to productive properties rather than according to acreage, a great deal of submarginal land in the United States would probably not have been put under cultivation; the problem of withdrawing it again from agricultural use, in the interest of efficient farm-land utilization, would not have arisen.

20–3. Dilemma of the Farmer. The traditional farm-land policy of the United States has given shape to the current pattern of American agriculture and contributed to the creation of farm problems. One of them is the highly competitive and individualistic character of agriculture. Over six million individual farming units attest to the competitive nature of agriculture. Any significant decline in postwar prices of farm products, due to declining demand at home and abroad, would tend to encourage individual farmers to maintain or possibly to expand production with a view to maintaining their income.

But should farmers, in general, increase or maintain production in the face of declining prices of agricultural products, as they did during the thirties, they would again discover that their gross receipts from farm marketings would continue to shrink because of the relatively inelastic demand for many farm products. If wheat, for example, sold at $2 per bushel, the farmer who disposed of his crop of 1,000 bushels at the market price would have a gross income of $2,000 from the sale of wheat. But if the market price of wheat were to decline some 10 per cent, and all farmers sought to maintain their gross receipts from the sale of wheat by expanding their

wheat plantings and increasing the wheat crop 10 per cent, they might find that the market price of their new crop had declined far more than 10 per cent, even without any shift in the aggregate demand schedule for wheat. Individual farmers would no doubt again be led to conclude that the harder they work and the more they produce, the less they get; while if they stop producing, or if their crops are destroyed, they get nothing, unless there are governmental subsidies for agricultural inactivity.

The perennial farm problem of low prices, shrinking incomes, and unsalable surpluses, which has confronted our highly competitive American agriculture in the past, has not been solved either by the various types of governmental aid to farmers during the interwar period, or by the abnormalities created by war itself. Inasmuch as the First World War contributed to the distortion of peacetime farm prices, production, and markets, let us next evaluate critically the several measures taken by the Federal government to solve the problems of American agriculture during the interwar period, and then formulate a program designed to strengthen the position of agriculture in our postwar economy.

20–4. Proposals to Help Farmers. *a. By Tariffs.* Shortly after the First World War, public policy designed to aid American farmers centered largely around efforts to increase the purchasing power of farmers by protecting domestic agricultural prices from being depressed by low prices of farm products in foreign markets through the imposition of tariffs.

b. By Dumping Abroad. As early as 1924, the McNary-Haugen Bill was pressed vigorously in Congress. In effect, it sought to impose high taxes on agricultural products, which were to be made effective by selling a portion of the agricultural commodities abroad at whatever prices they would bring, and preventing their reimportation by means of the tariff. Thus it was believed the domestically marketed supply could be decreased and its price raised. Losses on the portion exported were to be made up by an equalization tax on the total domestic production. Proponents of this plan maintained that the higher prices realized by farmers at home would more than cover the equalization fee, and thus would serve to increase the farm income.

However, it soon became apparent that the McNary-Haugen proposals, if put into effect, would encourage the expansion of agricultural production at home and perhaps invite the enactment of antidumping legislation abroad. The bill was passed by Congress but vetoed by the President.

20–5. Temporary Respite. For some years the agricultural situation seemed to improve without governmental aid. This improvement is indicated in the relatively high ratio of agricultural to nonagricultural prices after 1924 (see page 384). It was attributed not only to the expansion of the domestic markets for various farm products during the decade of prosperity of the twenties, but also to our liberal extension of foreign cred-

its, which helped to make possible the continued sales of agricultural surpluses in foreign countries.

The farm situation, however, changed rapidly for the worse after 1929. Prices of farm products and farm incomes decreased far more than did the prices of nonagricultural commodities and nonfarm incomes in the thirties. But, as previously indicated, the farm situation improved considerably after the outbreak of the Second World War.

20–6. Federal Marketing Act of 1929. *a. Purpose and Plan.* Taking cognizance of the continuing plight of American farmers in the late twenties, Congress passed the Federal Marketing Act of 1929. This act clearly recognized the need

> . . . to promote the effective merchandising of agricultural commodities in interstate and foreign commerce, so that the industry of agriculture will be placed on a basis of economic equality with other industries, and to that end to protect, control, and stabilize the currents of interstate and foreign commerce in the marketing of agricultural commodities and their food products.

Under this act the Federal Farm Board was created and vested with powers to aid in developing effective cooperative associations among farmers. The board was empowered also to stabilize the supply of agricultural products and to minimize price fluctuations by preventing surplus production as far as possible. To achieve these ends the Grain Stabilization Corporation was formed. With the aid of funds appropriated by Congress it began to buy up surplus wheat and to deal in wheat futures, with a view to pegging the market price of wheat. Similar stabilization operations were undertaken in cotton.

b. Failure to Raise Farm Prices. But the governmental price-lifting policies did not achieve the desired control of production. On the contrary, as was to be expected, the output of certain basic crops, such as wheat, corn, and cotton, was actually larger in 1931 than in 1929.

The failure of the Federal Farm Board to control agricultural output invited further Federal legislation to solve the vexing problem of unsalable farm surpluses. The suggestion that benefit payments in one form or another be made to farmers in return for their voluntary agreement to restrict acreage of marketable crops under cultivation was ultimately crystallized in the first Agricultural Adjustment Act in 1933, popularly called the "AAA."

20–7. Agricultural Adjustment Act of 1933. This much-debated emergency legislation was designed primarily to aid in increasing the monetary buying power of farmers by inducing them to restrict output voluntarily, with a view to raising the prices of what the farmers sold, relative to prices of the goods the farmers had to pay for what they bought.

Fundamentally, the declared objective of the Agricultural Adjustment Act was to achieve a balance of production and consumption of agricultural

commodities by restoring the ratio between the prices of farm products and those of nonagricultural commodities existing before the First World War. In order to achieve this objective, the Secretary of Agriculture was authorized to enter into marketing agreements with producers, processors, and distributors of certain basic farm products.

In accordance with the provisions of the act, a tax was levied on the first domestic processing of these products. This processing tax was added to price and shifted to consumers. Funds obtained from this tax collected from processors were applied to making benefit payments to farmers who had voluntarily agreed to acreage reduction.

20–8. Attack on Agricultural Adjustment Legislation of 1933. The agricultural adjustment legislation of 1933 was attacked both on economic and on legal grounds. The economic unsoundness of restricting output with a view to raising prices was seriously questioned. It should be borne in mind that prices of products may be raised not only by restricting supply but also by expanding demand. The former method tends to increase scarcity and, if carried to its logical conclusion, would make for poverty. The latter method concentrates on widening markets, with a view to increasing want satisfactions growing out of a larger consumption of farm products; it would make for prosperity or a relative abundance of goods. The agricultural adjustment legislation adopted restriction of supply to raise prices of farm products and was widely criticized in consequence.

Moreover, it was pointed out that acreage reduction "all along the line" resulted in withdrawing not merely marginal lands from cultivation but also superior lands. This made for uneconomical utilization of farm resources. It tended to leave some land of relatively low productivity in use, while other more productive acreage would either lie idle, or be devoted to less productive uses.

The AAA was finally declared unconstitutional by a divided vote of the United States Supreme Court,[1] early in 1936. The majority opinion of the Court held that Congress had invaded the rights of states and had exceeded its powers under the "general-welfare" clause of the Constitution, by authorizing the collection of processing taxes for payment of benefits to farmers, in return for crop restriction.

20–9. Further Governmental Aid to Agriculture. Further efforts to control crop acreage were made under the Soil Conservation and Domestic Allotment Act of 1936; but the effectiveness of all such legislation, designed to control supply, was revealed in the fact that the index of farm production reached a new high of 108 in 1937, as compared with 100 in 1929 and 96 in 1933. Large accumulations of basic farm crops continued to have a depressing effect on farm prices, relative to industrial prices.

In a further attempt to help the farmers, Congress passed a Second Agricultural Adjustment Act in 1938, providing for marketing quotas,

[1] *United States v. Butler et al., Receivers, Hoosac Mills Corporation*, 297 U.S. 288 (1936).

crop insurance of wheat, price-supporting loans to farmers by the Commodity Credit Corporation, and the storage of crops as an aid to achieving an "ever-normal granary."

During the years immediately preceding the Second World War, the Federal government also expanded the activities of farm credit agencies, developed the Farm Security Administration, and intensified the activities of the Soil Conservation Service. Moreover, prewar and wartime legislation was aimed at placing price floors under various farm products and extending parity price [1] guarantees into the postwar period. For example, the prices of tobacco, rice, peanuts, wheat, and corn were guaranteed at 90 per cent of parity for two full years after the official close of the war.

20-10. Critical Evaluation of Agricultural Adjustment Program. *a. Alleged Overproduction of Farm Products during the Thirties.* The agricultural adjustment legislation between 1933 and 1938 was intended to restrict market supplies of various farm products with a view to raising their prices and increasing farmers' incomes. But the often-repeated assertion that bothersome surpluses of farm products were due to overproduction in the United States, in the sense that there was no need for them, cannot be supported by facts. They constituted surpluses unmarketable at remunerative prices, due to the many man-made restrictions placed on both domestic and international trade, primarily since the First World War. Witness, for example, the trend toward increasing concentration of control in many branches of American industry, and the maintenance and extension of high tariff walls.

b. Improved Financial Status of American Farmers after 1933. It will continue to be a moot question whether the drought of 1934 or the Agricultural Adjustment Act of 1933 was chiefly accountable for the shrinkage in the supply of marketable farm products and for the consequent improvement in the financial condition of American farmers. Their improved status is indicated in the rise of the ratio of prices received by farmers, including benefit payments, relative to prices they had to pay for what they bought. Using the average from 1910 to 1914 as the base, 100 per cent, this ratio increased from an index of 55 in March, 1933, to 93 in 1936, or 69 per cent. Although it declined somewhat in the following three years (see Table 14 on page 384), wartime advances in farm prices raised it to a new high of 119 in 1943, which level changed only slightly for the duration of the Second World War. Moreover, the farming income situation also improved somewhat after 1933 until, as noted previously, it reached the wartime peak in 1945. Literally as well as figuratively, many American farmers were "living in clover" during the Second World War as they had during the First World War. The interwar years, however, were barren.

c. Possible Long-run Effects of Crop-acreage Restriction. A long-run program of crop-acreage restriction in our postwar economy, with a view to

[1] "Parity prices" are analyzed on pp. 396–398.

maintaining relatively high prices of farm products, would be economically unsound. It would tax consumers to pay for land that was being withheld from production. Any public benefit payments to farmers, whether disguised as payments for soil conservation or otherwise, are in the nature of subsidies, which must be paid out of someone's income. They represent class legislation, which may be attacked both on legal and on economic grounds. Although the mechanism employed to pay farmers for acreage restriction under the 1938 Act was essentially different from that under the Agricultural Adjustment Act of 1933, the objectives were very much the same.

It is frequently contended that benefit payments to farmers in return for restricting crop acreage would merely be equalizing the benefits accruing to many branches of industry, because of the protective tariff. This line of reasoning assumes that it is possible to make one right out of two wrongs. The economic unsoundness of high protective tariffs, particularly in view of our international creditor status, which promises to be extended in our postwar economy, has been set forth in Chap. XIII.

Again, any continued curtailment of production of farm products, with a view to raising the prices of these commodities, would accentuate the problem of unemployment in the United States. It would mean not only a larger number of unemployed farmers but also a growing number of idle industrial workers. Millions of consumers, confronted with increased costs of foodstuffs, would find their ability to buy nonagricultural products curtailed. Declining demand for these commodities might lead to ruinous price declines, restriction of output, and more unemployment. Manufacturers might then appeal to the government, even as have the farmers, to aid in lifting the prices of their products, with a view to restoring the former balance between agricultural and industrial output and between the prices of farm commodities and those of manufactured goods.

A long-run program of production restriction, whether in agriculture or industry, if carried to its logical conclusion, would lead to national impoverishment. The embarrassment of poverty is apt to be worse than the embarrassment of plenty.

Our economic system is not in imminent danger of reverting to the conditions of scarcity of the Dark Ages. But one should not lose sight of the fact that real income grows out of production. Even though a keen sense of social justice may prompt advocating a more equitable distribution of the national income between the agricultural and the nonagricultural population of the United States, it cannot be satisfied by a permanent policy of restricting output and narrowing markets in order to maintain or raise prices.

20–11. Farm Price Parity. *a. Inherent Inconsistency.* The Emergency Price Control Act of 1942 provided that prices of agricultural commodities

be permitted to rise to at least 110 per cent of parity prices. Farm price parity for various farm products is determined by, and changes with, not only the prices at which farmers sell but also those at which farmers buy. It thus expresses the ratio between the prices farmers receive and the prices farmers pay.

But a large part of what farmers pay out is for the purchase of farm products, such as feed, seed, and farm commodities in the form of raw materials entering into the production of industrial goods. As the prices of what farmers sell rise, there is also a resultant rise in the prices of what they buy, because of the necessary inclusion of farm products in farm purchases.

If prices of items purchased by farmers were to remain constant, parity prices, as defined above, would change proportionally with changing prices of farm products. But this is a condition contrary to fact. Thus it was estimated during the Second World War that if prices of farm marketings were to reach 110 per cent of parity prices, as permitted under the Price Control Act of 1942, the retail prices of food and clothing would increase 23 per cent. As prices of what farmers sold rose, prices of what farmers bought would also advance, even though at a slower pace.

b. Rigidity of Parity Prices. Rigid parity prices for farm products prevent the operation of open-market forces from adjusting prices to changes in production costs and demand. The basis for computing parity prices for many farm products goes back to the average of prices prevailing prior to the First World War. Many changes in demand as well as in production costs have taken place during the past 35 years. Man-hours required to produce 100 bushels of wheat have been reduced by 50 per cent since 1909 to 1914, while man-hour requirements to produce various vegetables are said to have increased. Any rigid parity price system fails to take cognizance of these changes in production costs, and so tends to distort normal open-market price relationships. Such distortion, in turn, makes for inefficient and uneconomical use of productive resources, since they will not be allocated among their alternative uses through the operation of competitive market forces.

c. Domestic and International Aspects of Parity Prices. Furthermore, the maintenance of domestic parity prices for agricultural commodities increases the difficulties of exporting surplus farm products. Subsidies for exports, such as authorized by Congress in 1944, may easily lead to international friction and invite retaliatory measures from foreign countries.

Moreover, an attempt to raise domestic prices of agricultural products above world prices is not conducive to promoting healthy international relations. A two-price system narrows, rather than widens, markets. Witness, for example, the restrictive effects on trade due to exchange controls and the separation of external from internal prices. Similarly, dump-

ing of surplus farm products below domestic prices makes for contraction rather than expansion of trade, even though it may serve humanitarian purposes.

d. Critical Evaluation of Parity Prices. In any critical evaluation of the farm price parity formula, it is important to consider how the rise in farm prices to parity levels comes about. If it were due to an increase in demand for farm products at home and abroad, it would indicate increased use of agricultural products by nonfarm consumers as well as by farmers. But if brought about by government subsidies to farmers, whether through purchase of surplus crops with a view to pegging farm prices and "dumping" surpluses abroad, or through liberal crop loans, or through payment for crop restriction, the resultant increased prices and money incomes of farmers will be largely at the expense of the nonfarming community. Let us assume, for example, that by one or the other of the above methods the government pushed up the price of wheat from $1 to $1.50 per bushel. The farmer would get 50 cents more for his product, but the consumer of the wheat would also pay 50 cents more in the form of higher prices for bread and wheat cereal. Thus what the farmer gains in purchasing power, others lose. Income will be redistributed, but not necessarily increased, by such farm price-lifting policies.

In view of both theoretical and administrative flaws in the proposal to achieve a balance between agricultural production and consumption by means of parity prices, let us consider the criteria of a sound postwar agricultural program. Since postwar agricultural production, based on independent decisions of millions of individual farmers, may again expand in the face of declining demand, due to restriction as well as dislocation of markets and marketing outlets, some governmental postwar guidance of American agriculture seems necessary.

20–12. Economic Basis of Postwar Program for American Agriculture. A sound program for American agriculture in our postwar economy should therefore be designed to assure wider domestic consumption of food products, discover new industrial uses for farm products, expand and maintain exports of farm products, aid farmers to reap the full benefits of low-cost mechanized production, and stabilize farm prices and income by increasing demand through continued productive employment of our economic resources, rather than by restricting the output of farm products.

a. Wider Domestic Consumption of Food Products. Instead of focusing attention on the need for adjusting production to demand, with a view to raising farmers' income, as has been done in the past, it would be economically sounder to concentrate on policies designed to adjust demand to production. In the final analysis, demand grows out of production, and farmers in the long run can hope to increase their demand for nonfarm products only as they increase their own agricultural output. But unless

there is a wider demand for the products of the farm, an unsold agricultural surplus will continue to glut markets and depress prices. Increased demand for farm products, in turn, requires increased production of nonfarm products. Moreover, wider demand for both agricultural and industrial products necessitates wider distribution of monetary buying power, making possible more extensive uses of the goods produced.

Even though the demand for basic foodstuffs is fairly inelastic, domestic food consumption could be expanded considerably, if the low-income families in our economy could afford an adequate diet. It has been said that one-third of our population is ill-fed, ill-clothed and ill-housed. While in 1935 to 1936, 10 million consumer units (families and single individuals) in the lowest income brackets in the United States, with incomes under $635, spent an average of $218 for food, the 10 million units in the upper bracket, with incomes of $1,715 and over, spent $685 for food, or more than three times as much.[1] While the money incomes in our postwar economy will no doubt be higher for all income groups than in 1935 to 1936, it is questionable whether the pattern of real-income distribution will be very different.

Providing an adequate diet for all of our people will aid considerably in increasing domestic food requirements and thus create an expanding outlet for farm products. The food-stamp plan and school-lunch programs developed during the thirties to augment food consumption by low income families may be extended in our postwar economy to aid in absorbing increasing quantities of farm products. It would seemingly be sounder economy to pay all workers a sufficiently high wage to make possible an adequate diet for all people in the country. But until such a goal is attained, some form of domestic food-allotment plan for low-income families should be included in any postwar agricultural program, aiming at widening domestic demand for foodstuffs.

b. New Industrial Uses of Farm Products. Moreover, further industrial uses for agricultural products are constantly being discovered. For example, in the manufacture of Ford cars, in addition to the use of wool, cotton, leather, mohair, and bristles, the following farm products are used: corn products for rubber substitutes and alcohol, flax for linseed oil and linen, and sugar cane for antifreeze mixtures and solvents.[2] Even soy beans have been employed in the manufacture of motorcars, the oil being used in the paints and varnishes, and the meal in the production of switch buttons, gear-shift knobs, etc.

New uses for farm products are often being suggested. It has been demonstrated that pine saplings of 7 years' growth, raised on southern

[1] National Resources Committee, "Consumer Expenditures in the United States," p. 85, 1939.

[2] *The Country Home*, May, 1935.

lands, make excellent wood pulp. Paper produced from this cellulose costs considerably less than paper made of Canadian wood pulp.[1]

Furthermore, considerable progress has been made in prewar years in the manufacture of motor fuels from agricultural products. Tests covering 20,000 miles in various makes of privately owned cars are said to have shown an 8 per cent better mileage with a 10 per cent blend of grain alcohol and gasoline than with pure gasoline.

Our known reserves of mineral fuel oils are limited, and fuel made of agricultural products may eventually supersede them. It has been estimated that between 80 and 100 million acres of crop land might be employed to meet the annual American requirements for motor fuels. This suggests a possible future domestic outlet for some of the staple crops of American farms. It is as yet too early to say how the development of atomic power for peacetime pursuits will affect the industrial demand for farm products. But the many suggestions that have been made indicate an almost limitless demand.

The first book printed on paper made of cornstalks was published in the United States in 1928. In 1935 an experimental half-mile motor road made of a product manufactured of cotton was laid in blanket form on a Mississippi highway. It provided both a durable and a flexible covering.[2]

All these actual and potential uses of farm products offer fruitful suggestions for further widening market demand for agricultural products. They indicate sound means of approaching the solution of the problem of low farm incomes.

c. Wider Foreign Markets for Farm Products. Not only increased domestic consumption of farm products but also wider peacetime foreign markets are needed to aid the American farmer in solving his difficulties. Without exports of cotton, tobacco, wheat, and corn products, our cotton acreage would have to be reduced by about 50 per cent, our tobacco acreage 40 per cent, and our wheat and corn acreage nearly 15 per cent.

In consequence of such acreage reduction, if our peacetime export markets for these products were lost, upward of a million farmers would have to be absorbed in other pursuits, or continue to be unemployed. Putting them on subsistence farms would be condemning them to permanently lower living standards. The detrimental effect of loss of foreign markets upon employment in allied activities, such as transportation, shipping, and storage should not be overlooked.

While our net exports of farm products were abnormally high during the Second World War, retaining foreign markets for American agricultural

[1] "Proceedings of the Dearborn Conference of Agriculture, Industry and Science," pp. 46*ff*., Dearborn, Michigan, 1935.

[2] Further industrial uses for farm products are suggested in *The Magazine of Wall Street*, Jan. 18, 1936.

products after the war is not a simple problem. Expansion of exports will, sooner or later, also necessitate increased imports, if we are to receive payment for our exports. This suggests the need for downward revision of tariffs, to which policy powerful business interests have traditionally been opposed. Moreover, we have no assurance that foreign countries will lower their tariff walls to permit increased sale of American farm products in their countries. Many foreign governments encouraged domestic production of agricultural crops, especially after the First World War, by erecting tariff walls and adopting other controls designed to restrict imports of competitive products.

Nevertheless, our national policy in the postwar era should be directed toward widening foreign markets for American products and increasing our purchases abroad. This is essential if we would maintain high levels of productive employment and achieve a sound economic balance between agriculture and industry. Such a policy may be promoted by further extension of reciprocal tariff agreements, which aim at expanding imports of diversified products and increasing sales abroad.

Moreover, it can be furthered by the restoration of a sound international currency, so that exchange rates will be held reasonably stable as had been provided for by the International Monetary Fund. Again, expansion of exports of agricultural as well as of industrial products can be stimulated by the reduction and eventual removal of such artificial barriers as quota restrictions, vexatious customs regulations, and restrictive exchange controls, which were widely employed in the interwar period by various countries. Finally, international commodity agreements, participated in by both producing and consuming countries, will serve as aids in regulating production and prices of such essential commodities as wheat, cotton, sugar, rubber, and coffee. These agreements should seek to encourage production in relatively low-cost areas and discourage production in high-cost areas, with a view to maximizing the benefits of territorial division of labor.

d. International Cooperation in Meeting World Food Requirements. In 1945 the United Nations Food and Agricultural Organization was created, in order to achieve an orderly development of adequate food requirements for the peoples of all countries. The 47 nations represented at the conference of the Organization in Copenhagen in 1946 set forth its purpose "to develop and organize production, distribution and utilization of basic foods, to provide diets on a health standard for peoples of all countries and to stabilize agricultural prices at levels fair to producers and consumers alike." Through active cooperation with the United Nations Food and Agricultural Organization, it should be possible to expand postwar markets for American farm products, and thus aid in maintaining remunerative prices and high levels of farm incomes, by concentrating on increasing demand

rather than on restricting supply. The Director General of the Food and Agricultural Organization, Sir John Orr, has called this organization "the world's answer to the atomic bomb. If nations can't get together on food, they can't get together on anything else. If they can, they will open the way toward other lines of cooperation that are essential to prosperity and peace."

e. Lowering Costs and Extending Credit. Lowering costs of production of agricultural commodities has frequently been stressed as an effective means of raising the net income of farmers. Much progress in this direction was made in the interwar period. While farm employment decreased since 1910, farm output per man-hour and per acre rose at a rate several times greater than the growth of our population. Farm productivity was accelerated particularly during the Second World War, being 30 per cent higher in 1944 than in the 1935 to 1939 period.

The Federal government, through its various credit agencies, has aided materially in reducing fixed costs of many farmers. The Federal Farm Credit Administration, created in 1933, refinanced farm mortgages and so helped prevent many foreclosures. The burden of fixed costs on American farmers could no doubt be further reduced if farm real-estate taxes were based on current incomes from farms, rather than on market values of farm real estate, which is the established practice.

f. Land Reclamation and Soil Conservation. A better farm-land-utilization policy is a primary requisite for a long-run expansion program of American agriculture. In 1934 the Department of Agriculture established a land-policy section in the Agricultural Adjustment Administration that cooperated with the National Resources Board, the Federal Emergency Relief Administration, and various other governmental agencies in formulating a national program of land utilization. This program involved the withdrawal of submarginal farm lands from agriculture and using them for forestry, recreation, and wild-life conservation, as well as the prevention of reoccupation of abandoned farm lands for agricultural purposes.

Crop rotation to prevent soil erosion and soil depletion has been a further part of the Federal farm-land-utilization program, which promises to be extended in the postwar era. All such measures will tend to promote the more efficient use of farm lands. The extension of scientific methods of planting, cultivating, and harvesting crops, as well as the increasing mechanization of agriculture all point toward increasing efficiency and lowering costs of production on the farms.

g. Increasing Efficiency and Reducing Waste. Readjusting the size of farm holdings to more economical units will also aid in lowering production costs of agriculture. Efficient use of costly agricultural machinery requires a larger acreage than that of the current American farm unit. It has been estimated that, on an average, tractors have been used less than

500 hours per year on American farms, but over 1,400 hours per year on Russian farms. Between these two extremes there is, no doubt, a point at which the most efficient use of farm tractors can be realized. Again, as has been demonstrated in agricultural experiment stations, better seed selection and improved fertilization also make for increased production per acre and per man, thus reducing unit costs of production.

Conquering plant insects suggests still another possibility of decreasing farm costs. It has been said that for every dollar a farmer earns a dollar is lost to him because of crop pests. Greater efficiency in marketing organization through further cooperative efforts will also make for agricultural economies. The Agricultural Marketing Act of 1929 gave a decided impetus to such cooperation.

h. Conclusion. Only by attacking on many fronts the postwar agricultural problems that will grow out of the need for readjusting American agriculture to peacetime requirements, can we hope to deal with them successfully.

The broad economic objectives—wider demand and lower costs—briefly surveyed in the preceding pages must be made the basis of any economically sound solution of the farm problem. The progress of economic readjustment in our disorganized postwar world will be difficult, slow, and painful. But unless such readjustment is based on considerations of wider markets for farm products, increased consumption, and lower production and marketing costs, it will tend to perpetuate a lack of economic balance and may ultimately lead to chaos. Economic disorganization has contributed to world conflict in the past, and may do so again in the future. It will require both domestic and world cooperation to restore and maintain economic equilibrium between agricultural and industrial production, nationally as well as internationally, in the postwar era.

Guide Questions on Text

1. "The plight of American farmers in the interwar period has frequently been attributed to the disparity between farm and nonfarm prices." Explain and illustrate.
2. Account for the disproportionate shrinkage in income from farming during the thirties.
3. What evidence was there of unusual farm prosperity during the Second World War?
4. "Any pronounced shrinkage in postwar farm incomes will again accentuate the burden of fixed costs confronting farmers."
    a. What has been the trend in fixed costs of farmers in recent years?
    b. Do you agree with the above quotation? Reasons.
5. Relate the trend in prewar agricultural exports to the problem facing American agriculture.
6. In what important respects does agricultural production differ from many fields of industrial production?

7. "The difficulties which may again face American agriculture in the postwar era are traceable in part to our traditional land-settlement policy."

   a. What was our land-settlement policy?

   b. How is it related to current farm problems?

8. Evaluate critically the various proposals and actions of the Federal government designed to aid American agriculture prior to 1933.

9. What was the declared objective of the Agricultural Adjustment Act of 1933? Evaluate this objective. Suggest others.

10. How was American agriculture affected by the agricultural adjustment legislation of 1933 to 1935?

11. "The agricultural adjustment legislation of 1933 was attacked on both economic and constitutional grounds." Explain.

12. Evaluate critically the agricultural adjustment program of the thirties.

13. Analyze the possible long-run effects of crop restriction on our economy.

14. Explain what is meant by farm price parity, and indicate the difficulties involved in achieving such parity.

15. Criticize the general policy of farm price parity.

16. What should be the objectives of a sound economic program for American agriculture in the postwar era?

17. How may these objectives be attained?

18. "It will require both domestic and world cooperation to restore and maintain economic equilibrium between agricultural and industrial production at home and abroad in the postwar era." Do you agree? Give reasons for your viewpoint.

Topics for Investigation

1. Changes in export markets for American farm products.
2. New uses for agricultural products.
3. Trend in fixed costs on American farms.
4. Need for social control of agricultural production.
5. Economic and social significance of farm price subsidies.
6. Development of cooperatives in American agriculture.
7. Arable land needs to meet adequate food requirements.
8. Trends in labor productivity on American farms.

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CHAPTER XXI

CONSERVATION AND RESTORATION OF NATURAL RESOURCES

21–1. Setting of the Problem. In the preceding two chapters, consideration was given to those economic problems centering about the more efficient utilization of land for urban site and for agricultural purposes, respectively. For both these uses, land is limited in quantity and varied in quality. Urban sites are permanent in their physical location, but not in their economic value. Soil fertility, on the other hand, may be destroyed by man or nature, or both.

In its relatively short history the United States of America has lost one-third of its top soil and four-fifths of its standing saw timber. Many of its basic mineral resources are nearly depleted. Many varieties of formerly abundant wild life are almost extinct. More than one hundred million acres of cropland—enough to feed 40 million people—have been destroyed for further cultivation.[1]

Land reclamation is possible by irrigation or drainage, and soil conservation by the reduction of erosion through wind or water. Again, the mineral and organic substances necessary for vegetation can be restored by means of fertilization.

There are, however, many natural resources that are neither permanent nor readily replenished. They are destroyed through continued use or abuse. Their restoration by nature may involve long periods of time; some can never be restored or replenished. Consequently, the efficient utilization and wise conservation of natural resources is a fundamental economic and social problem.

21–2. Classification of Natural Resources. The extremes between easily restorable and irrestorable natural resources suggest a basis for classification as follows:

a. Those resources which are so abundant that there is no apparent need for economizing, either at present or in the future. This is the case, for instance, with water in most localities.

b. Those which may become scarce in the remote future, but which, at present, are free goods in some localities, *e.g.*, certain building stones.

[1] Population Reference Bureau, quoted in *The Philadelphia Inquirer*, Mar. 27, 1948.

c. Those which are exhaustible with use, but which are restorable over a period of time, such as forests.

d. Those which are being wasted away by neglect and inefficient use, but which may be restored, at least in part, such as agricultural soil.

e. Those which are exhaustible with current use, but which are non-restorable, such as iron ore, crude oil, and coal.

The first two of these categories involve no current economic problems of conservation, but the last three groups do. It is around them that the following discussion centers. Before considering the conservation of specific resources, however, an understanding of the general concept "conservation" and its social implications is necessary.

21–3. Meaning of Conservation. Conservation has been widely used to mean the most efficient utilization of resources. In this sense of the word, conservation is synonymous with economy. The elimination of waste and the efficient use of natural resources may thus be regarded as conservation. But it would be enlightening to distinguish more carefully between these two terms. A few illustrations will serve to make clear this distinction between efficiency and economy.

The expansion of agricultural production, by increasing efficiency in the current use of farm lands, and thus lowering production costs, may make for wider uses of farm products at lower prices. But at the same time, it tends to create conditions contributing to more rapid soil erosion. Constant loosening of the topsoil and getting rid of weeds have made agricultural lands increasingly susceptible to the ravages of wind and water.

On the other hand, a monopolist of known reserves of a basic natural resource, such as anthracite coal, may restrict current output with a view to enhancing his monopoly profits. His ability to do so will depend on the degree of elasticity of demand for his product. But if he should create scarcity profits for himself by restricting output, the consumer would be paying a subsidy to the monopolist, who was retarding the rate of depletion of coal reserves. Such conservation, at present, does not necessarily imply economical production.

Thus economy and conservation are not the same. Economy implies the efficient current use of the scarce factors of production. It finds expression in the ratio of input to output. On the other hand, conservation involves retardation in the rate of disappearance or consumption of natural resources over a period of time. Economy may or may not result in conservation; and conservation may arise out of uneconomic, as well as economic, practices.

21–4. Need for Social Control over Exploitation of Natural Resources. Retardation of the rate of exploitation of either irrestorable or slowly restorable natural resources cannot be left to the automatic functioning of the competitive price system. If such resources are to be conserved, some

form of social control over their rate of consumption or destruction becomes inevitable. Whether they are exploited competitively or by a private monopoly, the purpose in either case is the same, namely, maximum present profitability, not present conservation for the benefit of future generations.

One would scarcely expect even a socially minded individual with the welfare of posterity at heart to abstain from exploiting his lands if a neighbor had struck oil on an adjacent farm. Nor can one look to private interests to invest capital in reforestation, from which a return can be expected only by future generations. In view of these considerations, conservation is distinctly a public problem involving social control and governmental regulation of the exploitation of exhaustible basic natural resources.

The belief is sometimes expressed that man's inventiveness and ingenuity can be relied on to discover substitutes, long before the reserves of basic resources have been exhausted. Thus it is claimed that there is no need for concern over the possible exhaustion of crude-oil reserves, since fuel alcohol, made of grain and waste products, can easily be substituted for gasoline. But in their final analysis, all forms of wealth have their origin in natural resources. The wasteful exploitation of certain resources will eventually be reflected in their increasing scarcity and higher costs.

21-5. Our Traditional Attitude toward Natural Resources. Until comparatively late in the nineteenth century, America was regarded as a land to be exploited, rather than to be developed. Her resources were viewed as inexhaustible. Indeed, some of them, like the forests, were considered obstacles to progress and development. The pioneer is generally pictured with either a rifle or an axe, to clear the wilderness of both the Indians and the trees behind which they lurked. It has been remarked facetiously that our early settlers first fell upon their knees and then upon the aborigines. The forests also were destroyed as frontier gave way to farm.

The westward march of civilization went slowly, because of the Appalachian Mountains and the forests that covered them. On the far side of the mountains, however, the pioneers found great, grassy, treeless plains. Now the frontier advanced rapidly, for free land, as noted in the previous chapter, could be had for the asking. The one-crop system of agriculture flourished, and when the land was exhausted, the group moved on farther into the great West. The individualism of the frontier was a philosophy that developed naturally because of the absence of a pressure of population on the apparently limitless natural resources.

The final exhaustion of free land may be regarded as marking the transition from an age of exploitation to a new era, out of which the conservation movement later developed. The great industrialization of the United States, which took place in the period following the Civil War, also gave

rise to serious thought. Were the coal fields to be exploited as had been the forests before them? The basis of our industrial future was at stake.

21-6. Conservation Movement in the United States. Although the modern movement for the conservation of natural resources has many roots, it is generally regarded as developing particularly from the efforts begun in the seventies of the last century toward the preservation of our national forests from complete destruction. A bureau of forestry was inaugurated in the Federal Department of Agriculture. In 1891, the first national forest reserve was established. Three years earlier, in 1888, an irrigation division of the United States Geological Survey had been established.

A close connection was observed between the forests and the water supply. Forest conservation became imperative for the preservation not only of the timber supply, but also of natural reservoirs of water. Deforestation of lands about the headwaters of the Mississippi River resulted in frequent floods in rainy seasons and recurring droughts in dry seasons throughout our central states.

In 1908 President Theodore Roosevelt established the National Conservation Commission, which undertook to make an inventory of the natural resources of the country. This was felt to be the first logical step in the study of the problem. Three published volumes gave the first authentic inventory of the natural resources of our country.

If the conservation movement was to develop to the extent that its importance demanded, it was necessary that a permanent national organization be created. Consequently, the National Conservation Association was formed in the autumn of 1909. It was to serve as a clearing association for all organizations doing related work. It was to function also as a great educational association for the propagation of the ideal of conservation. The National Conservation Association was organized as a Federal body, based on state representation; it was designed to foster the formation of similar state organizations.

The United States Forest Service also grew out of the study of the National Conservation Commission. Its activities have centered primarily around the protection of the forest resources in our public domain.

In 1924 the Federal Oil Conservation Board was created, to make a comprehensive study of the fuel-oil situation in the United States, and to suggest means of controlling the exploitation of oil resources. Furthermore, the Soil Erosion Act of 1935 directed the Secretary of Agriculture to coordinate Federal activities, with a view to controlling and preventing soil erosion. It also directed the Secretary to establish a Soil Conservation Service, to aid in carrying out the provisions of the act. It thus becomes apparent that for decades the Federal government has been actively concerned with the problem of conservation. But the national conservation

movement was revived during the depression of the thirties under the New Deal.

Before considering more specifically various private and public measures that have been either advocated or adopted to promote the conservation of certain natural resources, it is advisable to examine into the nature and importance of these resources. This study will serve to emphasize the need for thrift in their utilization. It is impossible to apply a uniform set of rules or principles to their conservation, since different resources vary not only as to their present and future usefulness, but also as to their visible reserves, the possibility of their restoration, and the methods of their conservation.

21-7. Forests. *a. Their Significance.* Forests are important natural resources, not only because of their timber, but also because of the part they play in the conservation of the soil. By maintaining soil moisture, forests ensure a regular source of water for the small streams that feed the large rivers. Thus, forests affect problems of wood supply, soil moisture, water power, and transportation.

The United States originally had a forest unequaled in extent and value by any other nation in the world. The Atlantic slope was well wooded and stocked with game of all sorts. The early settlers were forced to make clearings in the primeval forest by chopping down the trees and burning off their stumps. The wild life and forests disappeared together before the westward advance of civilization.

b. Forest Exploitation. The ruthless cutting of our forests continued long after the pioneer days of American history had passed. In the last two decades of the nineteenth century, for illustration, the increase in timber cut was almost twice as great as the increase in population. The Forest Service, in 1922, computed the rate of consumption of timber at four times its estimated growth. These figures were corroborated by President Coolidge, in 1924, in an address before the Conference on the Utilization of Farm Products. He pointed out that the annual drain of 25 billion cubic feet of timber was only partially offset by an annual timber growth of about 6 billion cubic feet. Currently (1948) the annual cut of timber for the country as a whole is estimated at five times the annual growth.

There is a qualitative, as well as a quantitative, aspect to the problem of forest conservation. Instead of selecting only mature trees, almost all standing timber in the area worked has frequently been cut by ruthless lumbermen. This method of forest destruction should be condemned most emphatically.

A further cause of much destruction of our timber supply is found in frequent forest fires. The average annual loss from this source alone has been estimated at over 65 million dollars. Forest rangers can prevent fires

from spreading only by early discovery of them and effective action against them. Hence, prompt fire detection and adequate protection are essential to the saving of both property and human lives.

Faulty taxation laws in many states have encouraged the destruction of forests. For tax purposes, forests have been evaluated on the basis of the amount of standing timber per acre, and, when once the timber was removed, the land was assessed at a lower figure, or possibly not assessed at all, since its value had been destroyed. Thus, timber exploitation became a means of tax evasion. This serves as another illustration of the unsoundness of the general property tax, discussed in Chap. XVIII.

c. Forest Conservation. The very nature of the problem suggests many remedial measures. In the interests of economy, as well as of conservation, it is unwise to cut down young trees. The maximum of timber production should be secured by cutting down only mature trees. Forests should constantly be picked over and not systematically destroyed. Again, reforestation is vital. Even though Arbor Day in the United States may not have had extensive material results, nevertheless it has served to educate the young people of this country to the importance of preserving tree life.

The history of the movement for conservation of our forests, until recent years, has been a story of public indifference and of political manipulation. In striking contrast to the repeated failures of Congress to act in the public behalf in the past, the efforts of a few public-spirited individuals, such as former President Theodore Roosevelt and Gifford Pinchot, one-time governor of Pennsylvania, stand out conspicuously. They stressed the necessity for setting aside certain forest reservations and emphasized the importance of Federal action.

d. Conservation Agencies. The *United States Forest Service,* previously referred to, was organized under the Department of Agriculture. It is charged with the duty of promoting efficient utilization of forests. It also carries on forest protection and conservation as well as extensive research activities relating to all phases of forestry.

As part of the Emergency Relief Administration during the depression of the thirties, the *Civilian Conservation Corps* was organized in 1933. This corps had planted half a billion trees in national forests throughout the country by the end of 1935. Moreover, to aid in soil conservation, 25 million trees were planted in land under both public and private ownership. In 1935, the Civilian Conservation Corps was widely suggested as a permanent organization to cooperate with Federal and state forestry agencies to carry out a long-range program of planting trees on publicly owned lands.

e. Forest Ownership. The issue of private versus public ownership of forest resources has long engaged the attention of students of economics and sociology. Under private ownership there has been much forest ex-

ploitation without adequate reforestation. Such procedure is sometimes referred to as timber mining. On the other hand, sustained-yield forest management has been called timber farming or cropping.

The time element is a fundamental consideration in economic appraisal of the feasibility of reforestation under private ownership of forests. Rapidity of growth has distinct commercial advantages, since it reduces the growing stock of timber capital, which must be maintained to yield a given annual cut of marketable product. The more rapid the growth, the shorter the rotation period during which capital is tied up in timber reserves necessary to assure a desired investment return. The inducement to a capitalist to invest funds in an enterprise that will yield a return 25 or more years in the future is obviously less than if the investment were to yield a similar return after 5 or 10 years.

With interest compounded at 5 per cent, and allowing for taxes, managerial expenses, and fire risks to standing timber, forests would have to double in value or quantity of timber output in about ten years to make such conservation profitable. But most marketable timber requires a far longer period for its growth. Hence the rapid and often wasteful cutting of timber by private owners, who give little thought to reforestation. Public ownership of forest reserves, therefore, is urged by advocates of forest conservation.

In this connection, the development of the business corporation, with its perpetual succession, attains increasing importance as a private business unit that may change the practices of exploitation and depletion of forest resources to a policy of long-run sustained-yield management. Corporations may maintain forest reserves to conserve capital and to avoid taxes on income from cutting and selling timber.

21–8. Water Resources. *a. Their Importance.* The water resources of a country are one of its most important assets. Among the many valuable uses of water must be mentioned first its vital place as a common necessity of everyday life for drinking, washing, cooking, etc. Modern civilization has brought the primitive spring into our very homes. It is said that a group of desert Indians were once introduced to the wonders of a modern American city. Upon being asked what they thought the most remarkable feature of modern urban civilization, they replied that it was the ability to obtain a stream of water in one's room at any moment, merely by turning a faucet. A city's pure and abundant water supply is indeed a great illustration of conscious adaptation of the physical environment. The serious consequences of lack of human control over water resources were dramatically emphasized during the great floods and droughts of the thirties.

The Flood Control Act of 1936 placed responsibility for flood control in the hands of the Secretary of War. The Secretary of Agriculture, on the other hand, was given authority over measures designed to prevent soil

erosion on watersheds. Control of water resources and soil conservation are mutually related problems.

In the second place, water resources are important as a method of transportation. In this connection, a word must be said concerning the waterways of our country. Although the development of railroads, motor highways, and airways has obscured their significance, the country is now turning back again to these waterways as an important supplement to our land and air transportation systems. They are especially well adapted for the carrying of cheap, bulky, and nonperishable freight.

In the third place, water is useful for irrigation. A large portion of our great West is arid. Irrigation can make up for an insufficient rainfall, and it has already transformed a large part of the "great American desert" into fruitful green fields of vegetation.

In the fourth place, our water resources are significant as a source of power. With the possible diminution of our coal supply and petroleum reserves, hydroelectricity will help to solve the power problem of the future. With coal and petroleum, the conservation problem has been one of inefficient and wasteful production, as well as one of inefficient consumption, but with water power the problem of conservation is one of insufficient utilization.

The distribution of our water power is as significant as its total amount. Many sections of our country, distant from sources of coal and oil fields, are bountifully supplied with water-power sites. Thus, New England, the South Atlantic States, the great Southwest, and the Pacific slope have little or no coal, but together they embrace over one-half of the potential water-power sites of the country.

b. Water Conservation. The conservation of our water resources, as well as our forests, is distinctly a problem of social control. As governmental regulation is similarly necessary, this economic problem also has a political aspect. Assuming that water resources should not be neglected, exploited, or monopolized, society faces the problem of what sort of governmental interference is most advantageous.

Many rivers in Europe run through several nations, and present international complications. But the United States is a single, unified country. Although continental in size, it belongs to only one nation. Moreover, the Constitution has given to Congress the right to regulate interstate commerce, and this has been held to include rights over navigation.

What the Federal government produces in the form of water power because of its improvements in the interest of navigation, it can sell or lease. This general thesis was sustained by the United States Supreme Court in 1936 in its decision pertaining to the Tennessee Valley Authority.[1] The same right holds for water power produced incidental to government irrigation projects.

[1] *Tennessee Valley Authority v. A. S. H. Wander et al.*, 297 U.S. 1 (1936).

c. Development of Federal Projects. Public expenditures for navigation and irrigation have been common, but until the passage of the Boulder Canyon Project Act, late in 1928, the Federal government hesitated to spend public money for the development of hydroelectric sites. Left to private enterprise, hydroelectricity has presented many legal questions as to the manner in which and the extent to which Congress may impose franchise taxes upon water power developed by private capital along navigable and unnavigable streams.

The Tennessee Valley Authority, created by act of Congress in 1933, represents the culmination of a governmental project which had its origin in the First World War, when a large hydroelectric power development was begun on the Tennessee River near Muscle Shoals. The dam and power plant were finally completed in 1927 and then lay idle while Congress debated whether they should operate under public or private ownership.

In 1933 the Tennessee Valley Authority Act provided for public ownership and transmission of power, first from Muscle Shoals and later from Norris Dam. The Tennessee Valley Authority project also represents a major public development in connection with water and soil conservation. "The land is changing. . . . The gullies are being healed. The scars of erosion are on the mend, slowly but steadily."[1] The Norris Dam also created a vast reservoir for power storage and flood control. Other Federal projects will be discussed in the chapter on public utilities.

d. Public Encroachment on Private Enterprise. The encroachment of the Federal government in the field of private enterprise by the generation and sale of surplus electric power in the Tennessee Valley precipitated a controversy, the repercussions of which will continue to make themselves felt until the issue of either public or private ownership and operation of basic utilities has been settled. This problem will be discussed in Chap. XXIV.

Individual states were formerly very generous in granting permission to private companies to develop hydroelectric plants on streams wholly within their state borders. Franchises frequently ran for very long periods of time and often contained valuable privileges, given without commensurate compensation on the part of the companies. In recent years, however, states have been more careful in granting franchises. New state constitutions, drafted within the last generation, speak of the water resources of the commonwealth as the property of all the people of the state. Indeed, they often inveigh against private monopolization.

21–9. Petroleum. *a. Its Importance.* Petroleum is important as the source of supply of gasoline, kerosene, lubricants, fuel oils, and many other valuable products. Its importance has increased with the growing use of the automobile. When "coal oil" was first discovered, kerosene was the most desired product. It was extensively used for lighting before the ad-

[1] Lilienthal, David E., "T.V.A.: Democracy on the March," p. 25.

vent of illuminating gas and later of electricity. The lighter distillations of petroleum, such as gasoline and benzene, were often thrown away as dangerous byproducts.

The invention of the internal-combustion engine, however, completely changed the situation; it made gasoline the most valuable product of petroleum. The future may hold in store the economical production of alcohol from farm products and waste, and its use as a fuel oil. But for the time being gasoline reigns supreme. Between 1881 and 1890 the United States produced on the average 55 million barrels of crude oil annually, or 50 per cent of world production, whereas in 1935 our domestic production amounted to approximately 990 million barrels, or 60 per cent of the total world production of petroleum for that year. On a per capita basis we produced about 4⁄10 barrel of crude oil per person annually during the eighties, while in 1945 we produced over 12 barrels per person, or nearly thirty times as much.

Although the gasoline engine is comparatively recent in origin, the consumption of gasoline has increased enormously because of it. The number of automobiles registered in the United States, including pleasure and commercial cars, amounted in 1947 to over 35 million, exclusive of publicly owned vehicles. Moreover, the navies and air fleets of the world are dependent upon a sufficient supply of gasoline and fuel oil. The industries of peace, as well as the agencies of war, are seriously concerned with our potential supplies of petroleum.

b. Petroleum Exploitation. The fact that the United States is well supplied with petroleum reserves for some years to come is no reason why this bounty of nature should be carelessly exploited. The production of petroleum in this country has more than doubled within each decade of the present century. The increasing world-wide demands for petroleum products, since the opening of the twentieth century, have been met very extensively by ruthless exploitation of our own oil deposits. During 1946, over 30,000 oil wells were completed in the United States, making the total number of wells drilled since the beginning of the oil industry in this country around 1,100,000.

About one-third of all the wells drilled for oil and gas have been dry. But scientific progress in prospecting oil fields has reduced this percentage somewhat in recent years. For example, in 1946, only about 30 per cent of the newly drilled wells were dry holes.

The large number of oil wells in the United States can be explained by the speculative and competitive nature of the oil industry. The location of coal in the United States is fairly well established, but the location of oil deposits is not so well known. Prospecting for oil has been like prospecting for gold in the days of the "forty-niners." The geological origin of petroleum is supposed to be the age-long application of heat and pressure upon

vast deposits of organic matter in the earth's crust. The present location of these deposits is even more uncertain than their past origin.

Petroleum was formerly discovered flowing from the surface of the earth. Now, however, engineers and prospectors are forced to drill deep down into the strata of the earth, on the mere chance of tapping some of these hidden reservoirs of petroleum. Better drilling methods were devised by engineers, until depths of more than 16,000 feet have been reached, whereas some years ago only a few wells exceeded a depth of 5,000 feet.

Because of technical progress and new discoveries, the proved domestic reserves of crude oil in the United States were 93 per cent larger in 1947 than in 1935, despite the enormous production of petroleum in the meantime. Yet in the period from 1938 to 1944 new oil discoveries in the United States fell below estimated annual peacetime requirements. This was, however, an abnormal period with wartime curtailment of prospecting, price controls, and inadequate equipment.

c. *Effect of New Discoveries of Oil.* The immediate effect of the discovery of "black gold" has been to multiply magically the number of oil wells in the vicinity. Anyone who owns land in the neighborhood of a successful oil strike, unless he "sells out," must sink a shaft on his lot in order to discover whether the subterranean lake of petroleum extends under his property. Otherwise, the first oil-well owner may soon drain, for his own profit, all or a large portion of that particular deposit.

Petroleum is a fugacious substance. According to the law of the land, its ownership is vested in him who first reduces it to possession, regardless of the possible source from which it comes. Consequently the discovery of oil by an individual on his land has led to its rapid exploitation, for fear that some neighboring landowner might obtain possession of it. This has placed a premium on haste and waste in draining underground reserves of petroleum.

A considerable portion of petroleum is brought to the earth's surface by the pressure of natural gas. Some of the oil production, when once started by man, is continued by nature. Much of it, particularly in the case of oil wells, must be pumped. Although there are effective means of holding such natural production in check, it is easy to see why individual producers may find it cheaper to let oil flow and sell it at any price, rather than to incur the cost of restricting the flow and thereby decreasing their immediate profits.

Under these conditions there has been the constant urge to bring every barrel of oil discovered to the surface as rapidly as possible. The economic waste of such competitive procedure is obvious. Hence the importance of effective regulation over the production of crude oil. Competitive exploitation and "natural" production, coupled with its strategic importance and tremendous demand, require social control of the petroleum industry.

d. Petroleum Conservation. (1) IMPROVEMENTS IN REFINING. In recent years, much progress has been made in the utilization of both crude oil and natural gas through the increased efficiency of refineries, the reduction of evaporation losses, and an improved process of cracking, or converting crude oil into lighter refined oils. In 1920 about 26 per cent of gasoline was obtained from the average barrel of crude oil; but in 1946, this percentage of gasoline amounted to 40 per cent. Moreover, chemists and engineers have devised ways and means to cement wells against the infiltration of salt water, as a result of which petroleum deposits under the ocean are now available for development.

(2) COOPERATION IN PRODUCTION. The wasteful mining of crude oil under conditions of competition cannot be eliminated merely by greater efficiency in its extraction and refinement. For years the American oil industry has been confronted with a condition of overexpansion, superinduced largely by its competitive nature.

Regulation and control of production, with a view to eliminating wasteful exploitation of oil resources at ruinous prices, was first undertaken by private producing agencies. In 1926 the oil operators appointed a field umpire in Oklahoma to cope with the situation developing out of excessive production. Yet not only was it difficult to obtain voluntary cooperation of many independent producers, but also there was the problem of possible violation of the Sherman Anti-trust Law, by combining to limit production with a view to raising prices.

Production control through private agencies has proved rather ineffective. Consequently, some form of governmental aid became increasingly necessary, if order was to be brought out of the competitive chaos in oil production.

(3) FEDERAL AGENCIES FOR OIL CONSERVATION. The *Federal Oil Conservation Board* was appointed in 1924. It made a comprehensive survey of the situation; and, acting in a purely advisory capacity, it offered a number of recommendations for conserving both oil and natural gas.

As part of the general program to codify industry under the National Industrial Recovery Act of 1933, a code of fair competition for the petroleum industry was adopted. State production quotas were specified, and allocations were subsequently made to each oil field. But when the Supreme Court invalidated the NIRA in 1935, the petroleum code, like other codes made under its authority, was terminated.

In 1935, the *Federal Planning Committee for Mineral Policy* reported to the National Resources Board that the limited reserves of oil and gas had been withdrawn so extensively that prompt adoption of a national policy to ensure a wiser and more efficient use of the remaining resources was imperative. The committee concluded that such a policy should be made to influence

. . . operators of petroleum properties (through technical and scientific knowledge) to use energy associated with the oil for moving it to the well and through the well to the surface, leaving a maximum of energy in the system available to do such work in the future, thus minimizing the quantity of oil to be left underground beyond recovery by ordinary means.[1]

(4) PRORATION OF OIL PRODUCTION. Proration and unit-pool operation have been extensively employed in recent years to regulate production of crude oil and to effect production economies. A number of states, including California, Oklahoma, Kansas, and Texas, have passed proration laws. By proration is meant control over production, exercised by some official body, so that all producers in the same field will be dealt with equally, as indicated by the quotas or allotments prorated among them. Engineers have been able to compute with a fair degree of accuracy the extractable fluid content of oil within specific property holdings. On the basis of such information, proration has been made possible, without multiple sinking of wells.

Proration has been criticized on the ground that it is inequitable because it hampers freedom of contract. It has also been argued that it is ineffective because more wells have been drilled than are necessary in order to get larger quotas. Finally, proration has been called uneconomical, since it tends to retard production from the more productive or low-cost wells and encourages production from the less productive or high-cost wells. Proration has been called cooperation among competitors in an "unnatural relationship."

(5) UNIT-POOL OPERATION. Unit-pool operation involves either the voluntary or compulsory cooperative exploitation of oil fields, "directed by a single authority to which individual owners or operators will surrender their private rights to independent operation in exchange for a share of the proceeds of the cooperative exploitation." [2]

Although unit-pool operation involves the difficult problem of allocation of product, it is in the interest of the most efficient operation of joint holdings. From the viewpoint of economical procedure it is thus to be preferred to proration.

(6) INTERSTATE OIL COMPACT AND THE CONNELLY ACT. The adoption of the Interstate Oil Compact, approved by Congress in 1935, should prove an effective aid in regulating the production of crude oil, in so far as it enters into interstate commerce.[3] The Interstate Oil Compact Commission has been working to achieve cooperation among the oil-producing states in the regulation of oil production.

[1] Quoted in "Minerals Yearbook, 1935," pp. 782*f*., U. S. Department of the Interior.

[2] ZIMMERMAN, ERICH W., "World Resources and Industries," p. 533, Harper & Brothers, New York, 1933.

[3] Ratified by Texas, Oklahoma, Kansas, New Mexico, Illinois, and Colorado before the end of 1935.

Moreover, the Connelly Act of 1935 specifically prohibited the transportation of "hot oil," *i.e.*, oil produced in excess of the quota allowed by state regulatory authorities, in interstate and foreign commerce.

(7) ECONOMIC INCOMPATIBILITY OF CONSERVATION AND COMPETITION. Public officials have, in recent years, awakened to the seriousness of the chaotic competitive conditions that have existed in the oil industry. Remedial Federal and state legislation should go a long way toward correcting many mistakes of the past; they should serve to promote in the future both economical production and genuine conservation.

But if social control should fail to curb competitive activities of independent producers in exploiting oil fields, their actions may defeat the purpose of such regulatory legislation. There are those who believe that conservation of an irreplaceable natural resource, such as crude oil, is incompatible with the institution of private ownership of land resources. The conflict between private and public interests looms up conspicuously in connection with the problem of conservation of our oil resources.

21–10. Natural Gas. *a. Its Extent and Importance.* Natural gas has frequently been found in connection with petroleum deposits, for both are of common origin. But more recently natural gas has been discovered also in other regions in the United States. It was most abundant in 1944 in California, West Virginia, Louisiana, Oklahoma, and Texas. The total natural gas marketed to ultimate consumers in the United States, in 1945, was 3.9 billion cubic feet. This included domestic, commercial, and industrial consumption.

The conservative use of natural gas is of importance since it is a commodity of great utility. It operates as a powerful natural force in driving the subterranean supplies of petroleum to the surface. The slowing down of the flow of oil soon follows the exhaustion of natural gas.

Furthermore, natural gas is the ideal fuel for the home, because there is no waste or refuse. It possesses about twice the heating value of manufactured gas. It is used extensively for industrial purposes in the regions in which it is produced, as, for illustration, in the glassmaking industry of western Pennsylvania.

The United States possesses the only well in the world producing a gas with a large helium content. As lighter-than-air craft are developed, this fact may attain increasing importance. It further emphasizes the need for wise utilization of such gas resources.

b. Exploitation of Natural Gas. The story of natural gas is a record of one of the greatest wastes in economic literature. Not many years ago, in towns located in natural-gas belts, street lamps often burned day as well as night, because this procedure was cheaper than the expense of hiring men to light them at night and to turn them off in the daytime. Frequently,

no meters were used for the consumption of natural gas, and the household consumer was charged a small flat rate.

c. Conservation of Natural Gas. The various ways by which natural gas might be conserved are too numerous to mention here. The chief source of loss, however, is in connection with petroleum waste. A more economical method of mining petroleum, such as unit-pool operation previously discussed, will result also in the conservation of natural gas. But in the regulation of the production of natural gas, as in the regulation of oil production, private ownership of land and the competitive nature of the industry militate against conservation.

21–11. Soil Conservation in the United States. *a. Extent of Soil Depletion.* Soil depletion in the United States presents a situation which affects the continued well-being of the whole nation. Future generations will feel the pinch of widespread poverty unless the present generation can be made to conserve our rural land resources.

> Soil-erosion specialists say that . . . one hundred million once fertile acres of farm land—equal to Illinois, Ohio, Maryland, and North Carolina combined—have been destroyed for profitable farming; that another hundred and twenty-five million acres are seriously impaired; and that another hundred million acres are threatened—all belonging to the best farm lands of the United States. Water and wind erosion generally each year dispose of, in so far as use is concerned, three billion tons of soil.[1]

At the prevailing rate of soil erosion in the United States it has been estimated that the United States has less than a hundred years of virile national existence left to it. Within fifty years only 150 million acres of really fertile land will remain in this country if the current rate of soil depletion continues. Such acreage is equal to only 40 per cent of the cropland under cultivation in the United States in 1944.

Not only croplands, but also Western grazing lands are rapidly approaching depletion through overgrazing and consequent soil erosion. Many localities in the United States are at present approaching uninhabitable desert conditions.

Soil erosion, due to the ravages of wind and water, has sounded the doom of many earlier civilizations. Aerial maps of various parts of Asia Minor, China, and Peru show striking similarities to some of the eroded areas in the United States, with gullied hillsides, rocky valleys, and dust-buried ruins. According to archeologists, once prosperous areas have been impoverished as a result of the ruthless and wasteful exploitation of fertile soils.

b. Kinds of Soil Erosion. The wastage of fertile soils may take on several forms. In the first place, there is sheet erosion, which consists in

[1] Cooke, Morris L., "An Engineer Looks at Rural America," Rural Electrification Commission, Washington, 1935 (mimeographed address).

the washing or blowing away of the top layers of the soil, in which the valuable plant nutrients are concentrated.

Sheet or surface erosion makes itself felt particularly where the surface of the land is not flat, but at a slope. Under such conditions the force of gravity seems to conspire with the force of water to accelerate the rate of destruction of the topsoil.

Second, there is gully erosion, which develops out of sheet erosion. It is characterized in its initial stages by the creation of shallow furrows. These gradually grow deeper and wider until they cut away entire fields and create deep ravines.

Wind erosion is a phase of soil erosion that received relatively little attention until recent years. However, it became increasingly damaging during drought years, such as 1934 and 1936. Terrific dust storms swept over the Middle West and carried particles of dust to the Atlantic seaboard and beyond.

Moreover, during winter months, areas not protected by a snow blanket have been subjected to dust storms that have whirled the topsoil in the air and exposed the roots of plants. In consequence, these winter crops have been severely damaged.

c. *Causes of Soil Wastage.* The high rate of soil erosion in the United States may be ascribed to numerous causes. The predatory agriculture of the past has resulted in depriving much of our soil of necessary surface protection against the ravages of the elements. By stripping away the natural vegetation that provided both roots and leaves to protect the land surface, millions of acres of our land have been exposed to the forces of wind and water. In consequence, streams have been choked with silt and made to overflow, and sand storms have covered highways to such an extent that snowplows have been used to clear sand from the roads.

Deforestation also, as previously noted, has contributed to soil erosion. Forest fires feed on the dry leaves and branches left after standing timber has been cut. This deprives the soil of the rich layer of vegetable matter called "humus" and bakes hard the surface of the earth. Instead of soaking into the ground, the rains run off rapidly, causing floods in streams and rivers.

Roots of trees, as well as other vegetable matter in the soil, act as sponges to absorb the water after a rain, and so prevent it from running off too rapidly. Where forest areas have been denuded, the soil has been deprived of its natural reservoirs. A scarcity of rainfall takes on the form of a drought in areas thus affected, leaving the land surface exposed to the ravages of the wind.

Again, the cultivation of annual crops has kept the soil constantly loose and thus subjected it more readily to the forces of erosion. It is another of the paradoxes of agriculture that the clearer a farmer keeps his fields of

weeds, the greater will be his current crop yield, but at the same time the more likely will he be to lose a part of his fertile land on account of wind and water erosion.

Finally, land speculation has accentuated the exploitation of the soil. High market values of farm lands, as during both world wars, have encouraged its more intensive utilization, without proper regard for its conservation. For example, the improved economic status of American farmers in general during the Second World War encouraged heavy drain of soil fertility, so that in some farm areas soil erosion actually increased between 1941 and 1945.

d. Prevention of Soil Erosion. (1) THROUGH PRIVATE INITIATIVE. Sheet or surface erosion may be checked by individual farmers through a modification of many of their traditional farming practices. They may adopt wise crop rotation, as well as more effective plowing, cultivation, and soil tillage.

Contour plowing rather than straight-furrow plowing is widely advocated as a means of checking soil erosion. By plowing and cultivating land at right angles to its slope, running water will be caught in the furrows and thus prevented from washing away the soil. Although many farmers have come to look on plowing skill as being demonstrated in the linear straightness of the furrows they plow, they are slowly beginning to realize that a straight furrow is not necessarily an economical furrow just because it represents the shortest distance between two points and is pleasing to the eye.

Farmers may construct small check dams and reservoirs to conserve water, but it is very doubtful whether individual farmers or farm owners could provide the necessary funds to pay for the construction of large reservoirs. However, as time goes on, the American farmer will come to realize that it is just as important to balance his horticultural budget as it is to balance his financial budget, and that the continued balancing of the latter will be facilitated by the effective balancing of the former.

In 1946 there were 1,650 soil-conservation districts in the United States, covering nearly two-thirds of the nation's farms and a total of about 900 million acres of farm land. "The districts are democratically organized and operated by groups of farmers who, in conjunction with state and Federal experts, study the problems of soil conservation." [1]

(2) THROUGH SOCIAL CONTROL. Even though the individual farmer may contribute to the conservation of the soil, the problem necessitates some form of social control for its effective solution. In view of the gravity of the situation, a national committee on soil erosion was appointed by the Department of Agriculture in 1929. Its detailed report clearly recognized the national menace of continued wastage of the soil.

[1] *The New York Times,* Editorial, Oct. 13, 1946.

In 1933 the Federal government launched an extensive program for the permanent protection of our land resources. It centered around the *Soil Erosion Service* of the Department of the Interior. This service was subsequently transferred to the Department of Agriculture under the title of *Soil Conservation Service.*

It began its work of conservation by establishing a series of demonstration watershed projects intended to conserve water, to maintain agricultural productivity, and to prevent further erosion of the soil. Out of these projects it was hoped there would grow comprehensive land-utilization plans and cooperative agreements between private landowners and the government.

Among the measures proposed under the program of the Soil Conservation Service was the withdrawal of submarginal croplands from cultivation and returning them to grazing or timber utilization. Moreover, terracing of slopes, constructing check dams, and the furtherance of crop-rotating systems were all included in the comprehensive conservation program.

The *Civilian Conservation Corps,* organized primarily to provide useful public employment for young men between the ages of eighteen and twenty-five, was not limited in scope to forestation of public lands. Congress also authorized the extension of its work to private lands through cooperative agreements. It built small dams of earth, brush, and other materials to arrest further gully erosion and planted trees and grass to hold the soil of eroded areas in place.

Individual landowners were permitted to ask the assistance of the Civilian Conservation Corps to check erosion of their lands, but in return for such aid they were required to sign contracts to maintain the works for 5 years.

In accordance with the provisions of the Soil Conservation and Domestic Allotment Act of 1936, farmers were to be paid for planting soil-conserving, instead of soil-depleting, crops. The scale of such payments was established by the Secretary of Agriculture. It ranged from $1 per acre for maintaining soil-building crops to $20 per acre for shifting lands from soil-depleting to soil-conserving crops. Soil-depleting crops correspond roughly to the major commercial crops, such as wheat, corn, cotton, and tobacco. Disbursements were made out of the 470-million-dollar fund appropriated for soil-conservation purposes by Congress under the provisions of this act.

The conservation movement, combined with crop-production control, was further extended under the Agricultural Adjustment Act of 1938. But while government soil-conservation programs during the thirties were generally related to production adjustment and the over-all crop pattern, as noted in the preceding chapter, postwar soil conservation should be separated from a program of production control.

This may best be done by expanding the work in conservation districts under the State conservation district laws and developing unified regional plans in areas where flood control, irrigation, forestry, and conservation are interrelated. At the same time the States should develop tenure legislation which will give greater security of occupancy of farms because insecurity of tenure is one of the major factors making for exploitative agriculture.[1]

Governmental payments to farmers for soil conservation should be related in the future to the physical conservation needs of our wasting land resources rather than to the historical pattern of the crops raised on the land, as has been the case in the past. The objectives of soil conservation and production control are not necessarily functionally related. "As we approach the middle of the twentieth century we are beginning to realize the vital importance to the national welfare of the natural resources." Moreover, "as the country becomes increasingly cognizant of the necessity of conservation measures there will be increasing opportunities for careers in healthful outdoor occupations"[2] in various branches of our national conservation programs.

Guide Questions on Text

1. What is meant by conservation of natural resources?
2. Classify natural resources, and indicate which of these classes involve the problem of conservation.
3. Distinguish between economical use and conservation of natural resources.
4. Why has social control over the exploitation of natural resources become necessary?
5. Account for our traditional indifference to the problem of conservation.
6. Trace briefly the development of the conservation movement in the United States.
7. What are some of the economic consequences of forest depletion in the United States?
8. "There is a qualitative, as well as a quantitative, aspect to the problem of forest conservation." Explain.
9. Explain why private ownership of forests is incompatible with forest conservation.
10. Analyze the economic importance of our water resources.
11. "The conservation of water resources is distinctly a problem of social control." Do you agree? Reasons.
12. Explain and illustrate types of social control of water resources inaugurated by the Federal government since the close of the First World War.
13. Trace the development of our crude-oil resources.
14. How has private exploitation of oil resources contributed to wasteful oil production?
15. Analyze the constructive steps that have been taken to conserve our oil resources.
16. "The story of consumption of natural gas is a record of one of the greatest wastes in economic literature." Explain.
17. What is meant by soil depletion?

[1] Bunce, Arthur C., Our Agricultural Policies, *Postwar Economic Studies*, No. 2, p. 20, Board of Governors of the Federal Reserve System, Washington, 1945.

[2] *The New York Times*, Editorial, Oct. 13, 1946.

18. Explain the causes and effects of soil erosion.
19. Distinguish among the several types of soil erosion.
20. Outline the elements of a constructive program for soil conservation.

Topics for Investigation

1. Public versus private development of water resources.
2. Costs of reforestation.
3. Conservation of natural gas.
4. Methods of soil conservation.
5. Relation between protective tariffs and exploitation of natural resources.
6. Oil imperialism versus oil conservation.

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Part Seven

PROBLEMS OF CAPITALISTIC ORGANIZATION

CHAPTER XXII

TRUSTS AND INDUSTRIAL MONOPOLIES

22–1. Fundamental Concepts. Monopoly is the opposite of competition. Absolute monopoly implies the complete absence of competition. A condition of absolute monopoly, however, is almost as rare as one of perfect competition. Between these two extremes are numerous gradations; such conditions are termed those of imperfect competition, monopolistic competition, or quasi monopoly.

Under economic competition there are several sellers and several buyers, often many in each of these two groups. Competitive prices are determined naturally by the free play of demand and supply forces. On the other hand, monopoly signifies a single seller, or several parties who do not compete with each other. Some sort of unity of action has been achieved, as a result of which the free play of price-determining forces is impaired.

To be exact, monopoly implies a single seller; duopoly, two sellers; and oligopoly, several sellers. Where control is exerted through concerted demand instead of supply, the term "monopsony" has been substituted for monopoly. Monopsony implies a single purchaser; duopsony, two buyers; and oligopsony, several buyers.

Perfect competition exists only where individual units of an article are identical and where individual producers or consumers are so insignificant that the presence or absence of any one seller or buyer cannot influence the price of the article by his offering or asking in the market. Imperfect competition, however, assumes the possibility of the substitution of one comparable but not identical article for another to meet the same or a similar demand. Imperfect competition may be illustrated by popular brands of cigarettes or toilet soaps of about the same price. Differentiation of product exists in the minds of buyers, but substitution is possible. Imperfect competition should not be confused with partial monopoly in the form of duopoly or oligopoly, where the supply of identical articles is controlled by two or several producers.

22–2. Source of Monopoly Power. The acid test of monopoly is power to regulate price. It is secured by concerted control over the chief sources of a commodity or service. Control over the entire supply is not necessary.

Although such power is generally secured through control of supply, it can be obtained also by concentration of demand. Thus, the "Big Five"

meat packers, the so-called "beef trust" of a generation ago, were alleged to have had such concentrated control over the meat-processing facilities of Chicago that their buying activities were more cooperative than competitive. Individual drovers, on the other hand, had to sell their cattle for whatever prices they could get for them before profits were eaten up by costs of feed and maintenance, while consumers complained of the high prices of dressed meats. The packers were in a powerful buying position because they could keep sufficient meat in cold storage to care for immediate market needs; they would buy cattle only at distress prices. The packers, therefore, may have been an oligopsony in buying cattle and an oligopoly in selling meat. A similar situation has existed in plants refining petroleum, the production of which, as we saw in the preceding chapter, was highly competitive. There have been many such bottlenecks in other industries, *i.e.*, strategic positions of concentrated control between weaker or competitive occupations.

The long-run trend of competitive price is toward costs of production. Under monopoly or partial monopoly, however, costs of production constitute merely a minimum level, above which price tends to rise to the point of maximum profit to the monopolist. How high this monopolistic price will go depends on whether the demand for the good is elastic or inelastic and whether the article is produced under conditions of increasing or decreasing costs. Elasticity of demand permits substitution and keeps prices down. Decreasing costs favor volume production, which requires mass consumption, possible only at lower prices.

22–3. Kindred Concepts. Although modern industrial monopolies are usually corporations, the advantages and disadvantages of the corporate form of business organization should be separated from those arising from monopoly. This distinction, however, is frequently difficult to make. Absentee capitalism, or the separation of ownership from control, which is apt to occur under the corporate form of business organization, facilitates concentration of control. Hence, the common confusion between monopoly and the corporate form of business organization.

Large-scale production and monopoly also are closely related and similarly confused. Most industrial monopolies are those of large-scale production, but all monopolies are not huge in size, even though supply is closely controlled. A small dealer may be a monopolist without possessing the advantages of large-scale production. The village grocer in a sparsely settled community, for illustration, may face so little competition that he can, within limits, regulate the prices of certain foodstuffs in that locality.

On the other hand, mere size does not of itself prove the existence of monopoly. This distinction was definitely stated in a decision of the United States Supreme Court [1] concerning the United States Steel Corpora-

[1] *United States v. United States Steel Corp.*, 251 U.S. 417 (1920).

tion, which had been prosecuted under the Sherman Anti-trust Act as a combination in restraint of trade. Although large-scale manufacture and management were demonstrated, the existence of monopoly in the steel industry was not proved. It was shown that the United States Steel Corporation held more power than any other competitor, but not that it held more power than all its competitors combined. Hence, the court held that no monopoly existed.

A "corner" represents a temporary scarcity that has been foreseen and taken advantage of by a shrewd enterpriser. The total supply of the commodity may not have been restricted in order to raise its price. The attempt to secure a corner, nevertheless, raises the price of a commodity by an abnormal increase in its demand. The chief feature of a corner, however, is its temporary character.

22–4. Old and New Concepts of Monopoly. Exclusive grants were formerly regarded as proper prerogatives of absolute monarchs. Queen Elizabeth rewarded her favorites thus. Monopolistic privileges were used also by the Stuart monarchs as sources of royal revenue until the practice was abolished by the rising tide of constitutionalism.

This older concept of monopoly was explained in the writings of Blackstone as "a license or privilege allowed by a king."

Adam Smith, who made competition one of the main pillars of his economic philosophy, regarded monopolies as exceptional and of legal origin; but he also recognized the existence of natural monopolies.

> Though some exclusive privileges arise from nature, they are generally the creatures of civil law. Such are monopolies and all privileges of corporations, which though they might once be conducive to the interest of the country, are now prejudicial to it.[1]

The new concept of monopoly is one of industrial concentration, rather than one of a legal grant. It has been stated by the Supreme Court of the United States as follows:

> The idea of monopoly is not now confined to a grant of privileges. It is understood to include a condition produced by the acts of mere individuals. Its dominant thought now is, to quote another, "the notion of exclusiveness or unity"; in other words, the suppression of competition by the unification of interest or management, or it may be through agreement and concert of action. And the purpose is so definitely the control of prices that monopoly has been defined to be "unified tactics with regard to prices." It is this power to control prices which makes the inducement of combination and their profit.[2]

Thus, modern judicial decisions have striven to express the new concept of economic power, as opposed to the older idea of legal grants. Ability to

[1] Canaan, Edwin (editor), "Lectures on Justice, Police, Revenue and Arms," pp. 129–130.

[2] *National Cotton Oil Co. v. Texas,* 197 U.S. 129 (1905).

regulate prices has been considered the chief incentive to combination and the best test of monopoly.

22–5. Kinds of Monopoly. Monopolies may be classified according to their extent over time or territory. A distinction has already been drawn between durable monopolies and temporary corners. It is possible likewise to differentiate among local, national, and international monopolies.

Monopolies, as just indicated, have been classified also as legal or economic in nature. Legal monopolies are those arising from a governmental grant of exclusive privilege or unusual power. Legal monopolies, in turn, may be divided into public and private monopolies. The post office illustrates a public legal monopoly; patents and copyrights exemplify private legal monopolies.

Economic monopolies are of two general types: those which exist because of a natural scarcity of some particular good, and those which develop in an industry in which competition is unprofitable and much capital is essential. Certain mineral waters and the skill of a great surgeon are natural monopolies due to the scarcity of these particular commodities and services. Natural monopolies of organization, by way of contrast, include those industries in which competition is self-destructive. Such industries require much fixed capital and carry heavy overhead or indirect costs on the capital invested, whether it is used or idle. Examples are railroads, waterworks, and electric power plants. As the volume of business increases, the cost per unit decreases, because indirect costs are spread over a larger number of units. Hence, these industries are known as natural monopolies of organization in which competition is undesirable. They will be discussed in Chaps. XXIV, XXV, and XXVI, devoted to public utilities and railroads.

An attempt has been made to distinguish between monopolies resting on productive efficiency or the futility of competition and those relying on superior bargaining power or pecuniary strategy, *i.e.*, between "good and bad monopolies." This distinction is somewhat similar to that between natural and artificial monopolies, or between public utilities and industrial trusts, which are the subject of this and the following chapter.

The term "trust" is a corruption of the word "trusteeship," a device employed to achieve monopoly. As used in its popular sense for the title of this chapter, the trust refers to business combinations. These industrial monopolies or trusts should be differentiated from legal monopolies and public utilities.

Again, business combinations may be grouped according to their closeness or looseness of organization. At the one extreme is complete corporate unity achieved through a consolidation or merger of smaller into larger concerns. At the opposite extreme is the cartel or pool, which seeks unified policy, but which preserves the corporate independence of the individual

companies. Between these two extremes is a combine or concern that achieves unity by means of a holding company owning stock in its subsidiary or operating companies.

Finally, there can be monopolies of labor as well as of capital. Trade unions sometimes raise the qualifications of apprentices in order to limit the number of workers in their particular trades. By such curtailment of the supply of certain skilled workers, wages in those restricted occupations are raised to higher levels. Illustrations of such labor monopolies are the medieval craft guilds and the modern closed shop with the closed union.

22–6. Causal Factors in Evolution of Trusts. The modern trust is the outcome of technological improvements and financial devices developed since the Industrial Revolution. It is the final stage in the long tendency toward increased concentration of capital, the greater use of which was necessitated by machinery and large-scale production.

The invention of power machinery substituted the factory system for the domestic system of manufacture. Early factories were small, but larger plants gradually developed. Small-scale manufacture was followed by

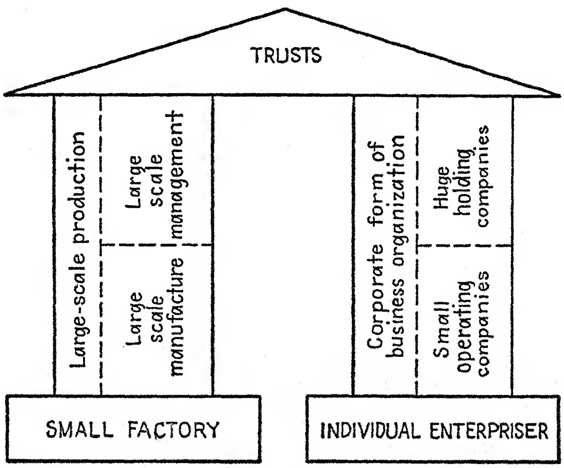

CHART 10. Evolution of trusts.

large-scale manufacture, and large-scale manufacture by mass production and concentrated control. In many cases, monopoly was the final step.

Industrial growth was paralleled by financial expansion. Just as the small water-power mill was supplanted by the huge steam factory, so the single enterpriser has given way in most large industries to the corporate form of business organization. Finally, super corporations and financial combinations appeared. Capitalization in millions, and even billions, has succeeded that in thousands of dollars. The holding company, a security-owning corporation, facilitated the combination of individual corporations

in the same way that the corporation itself permitted the combination of numerous individual investors.

The modern trust is the product of these two interrelated economic developments, the one technological and the other financial. Chart 10 pictures the trust resting on these two pillars, the one large-scale production, the other the corporate form of business organization.

22–7. Industrialization and Large-scale Manufacture. Although the history of many American manufacturers can be traced back to the War of 1812, some even to Colonial days, the great industrialization of the United States did not take place until the period following the Civil War. Mechanization of industry and complicated processes hastened the transition from small-scale to large-scale manufacture. Indeed, the economical use of some new machinery and improved processes necessitated large-scale manufacture.

The size and output of individual plants in many industries increased out of all proportion to their growth in number. During the last half of the nineteenth century, for illustration, the number of establishments devoted to the manufacture of textiles and shoes changed but little, although the number of employees involved and the amount of capital invested therein multiplied several fold. During the same period the number of establishments devoted to the manufacture of agricultural machinery and the number of iron blast furnaces actually decreased one-half, while the total output of both industries grew to several times their former capacities.

22–8. Decentralization of Industry. This expansion in the size of manufacturing plants has not been universal or continuous. The Hoover Committee on Recent Economic Changes testified to the prevalence and efficiency of the relatively small manufacturing establishments in many industries. Today electricity is supplementing and even supplanting steam as motive power for many purposes. The future may witness the further development of hydroelectric power and perhaps the utilization of atomic power. Yesterday, the age of steam; today, that of electricity; tomorrow, that of atomic energy.

Individual plants now have ready access to cheap electric power, bought from great public-utility companies, which manufacture electricity on a large scale and transport it great distances. Such a technological development may be accompanied not only by the movement of manufactures from big cities to small towns, but also by the economic revival of small manufacturing plants. Changes in the arts of production, which, in the past, made for the concentration of industry, may, in the future, work toward industrial decentralization. It may be hastened by the danger of destruction by atomic bombs.

It is not to be inferred from this suggestion, however, that financial concentration is likewise on the wane because of these technical changes in methods of manufacture permitting the survival of small plants.

22–9. Combination and Large-scale Management. The development of large-scale management came somewhat later than that of large-scale manufacture. Popular apprehension about concentration of control in industry finally expressed itself in the Sherman Anti-trust Act of 1890. In spite of such restraining legislation, however, industrial combination went on even more rapidly. The number of combinations formed and the capital represented therein were seven times as great in the last decade of the nineteenth century as in the previous thirty years.

Combination within industry continued apace during the opening years of the twentieth century until checked by active intervention of the Federal government. Prosecutions were vigorously pushed against many trusts during the administrations of Presidents Theodore Roosevelt, Taft, and Wilson. But participation in the First World War turned popular attention from such domestic difficulties to broader problems of international affairs.

The postwar period was another era of industrial concentration. Wartime experience taught many hitherto unorganized industries what combinations already had learned, namely, that competition was wasteful. Consolidations and mergers in the twenties exceeded in number and size the industrial combinations that had previously taken place. During the administrations of Harding, Coolidge, and Hoover, big business was triumphant, not persecuted.

In the period of depression, between the stock-market crash of 1929 and the emergency of the Second World War, however, big business was held suspect. Nevertheless, as we shall see later, the National Industrial Recovery Act temporarily suspended the Sherman Act and authorized business cooperation through industrial codes. But the New Deal of Franklin D. Roosevelt, like the "Square Deal" of Theodore Roosevelt, marked an abrupt turn in our national policy. The mandate of the people at the polls in 1932 brought drastic financial legislation and vigorous renewal of trust prosecution, until the outbreak of the Second World War again diverted public attention from domestic to foreign issues.

22–10. Recent Financial Concentration. A survey [1] showed that 130 corporations, each reporting assets in excess of 100 million dollars, controlled 82 per cent of the assets of a group of 573 corporations, whose shares were traded on the New York Stock Exchange in 1929. Among some 300,000 nonbanking corporations, on or about Jan. 1, 1930, the 200 largest, each with assets of more than 90 million dollars, controlled between 45 and 53 per cent of the nonbanking corporate wealth; between 35 and 45 per cent of all nonbanking business wealth; and between 15 and 35 per cent of the total national wealth.

At the end of the Second World War, the War Production Board estimated that there were outstanding prime contracts for 65 billion dollars'

[1] Berle, A. A., and G. Means, "The Modern Corporation and Private Property."

worth of goods yet to be delivered. Approximately 85 per cent of this huge amount, *i.e.*, about 55 billion dollars' worth of prime contracts, was held by one hundred corporations and their subsidiaries. Indeed, 45 per cent, or about 29 billion dollars' worth, of these war contracts was held by only ten corporations and their subsidiaries. Although there had been much subletting to small producers, most war work had been funneled through big producers.

This revived tendency toward industrial and financial combination may be explained partially in terms of a changed popular attitude and a revised governmental policy toward the trusts. The following chapter will show that both the possibility and the desirability of "trust busting" were challenged by public opinion and judicial decision. Legislation first opposed combination, then tolerated it; finally, government encouraged, or, at least, utilized big business.

22–11. Large-scale Marketing. The rise of the chain store is another chapter in the long story of industrial combination. It represented the development of large-scale marketing, as well as large-scale manufacturing; the products of mass production were sold at low prices in chain stores and supermarkets.

The economies of the chain store are those of direct buying from the manufacturer in large quantities at favorable prices. Again, there are advantages of standardization of equipment and technique, as well as those of centralized and coordinated administration. Finally, many chain stores operate on a cash-and-carry basis in order to avoid delivery expenses and credit losses.

The department store is another form of large-scale marketing. Whereas chain stores operate similar outlets in different places, the department store conducts various departments under the same roof. This is a convenience to the customer; it is also a managerial economy because of the maintenance of a single delivery, credit, and personnel service for all departments.

Small, independent merchants are struggling desperately for existence against chain stores and department stores. The issue is not merely between ruinous competition and ruthless combination, for there is the further possibility of cooperation in purchasing goods by independent merchants. The cooperative movement in its various phases will be discussed in a later chapter.

22–12. Loss Leaders and Chain Stores. One of the chief criticisms brought against the chain store has been its utilization of loss leaders, a practice regarded as unfair competition. A loss leader is a staple article, such as sugar or some nationally known brand of goods, that a chain store advertises for sale at a price lower than that which generally prevails, and sometimes at a price that is less than its cost. A loss on this leader, the low price of which brings customers into the store, is generally made up by profits on other goods sold to those attracted by this bargain.

Anti-chain-store bills, most of which proscribed loss leaders or limited price cutting, have been introduced in the national Congress. Some states have passed specific anti-chain-store laws or have imposed special taxes on those organizations. Other states have acted positively instead of negatively in this matter by permitting, and sometimes even promoting, price maintenance, especially of advertised brands. The constitutionality of extreme anti-chain-store laws has been contested in the courts. The inconsistency of these laws that restrict competition with those laws seeking to preserve competition is obvious. This will be developed more fully in the following chapter dealing with regulation of the trusts.

22–13. Survival and Success of Small Businesses. It has been alleged that the survival of capitalism is threatened by the decreasing importance of small business, the decline of competition, and the extension of monopoly, oligopoly, and quasi monopoly. There seems to have been a definite and perhaps a dangerous trend toward the combination of many small, independent business units into a relatively few, large concerns that dominate their particular industries either by productive economies or by the financial strategy of unfair competition.

Contrary to popular belief, however, a recent study by the Committee for Economic Development reports that small business has not been losing its relative position in our national economy, at least from the standpoint of the comparative numbers of large and small firms. Indeed, small business, so the survey finds,[1] has shown itself to be both virile and durable over the past half century. Even during the Second World War, when most government orders were funneled through large corporations, small business units were fairly successful in subcontracting for a substantial portion of this industrial output.

Statistics used in the report[1] indicate that there were a million more small firms in the nation in the years immediately following the Second World War than there had been in 1900, which is not surprising in view of the country's great economic development in that half century. Even more significant, however, is the finding that the ratio of small businesses per thousand of population has remained fairly constant throughout these fifty years. Defining a small business, arbitrarily but reasonably, as one which has less than 50 employees, 98 per cent of all business firms were still small at the close of the Second World War; they were doing 35 per cent of the total volume of all business done in this country, and they were providing for 45 per cent of all those engaged in business as employers or workers.

The report contends that in many lines of economic endeavor, the small firm is more efficient than big business. It can get into action more quickly and operate more flexibly. During the Second World War, for example,

[1] Kaplan, A. D. H., "Report on Small Business," Committee for Economic Development, 1947.

the tremendous output of some huge manufacturing plants was possible only by the cooperation of many small, specialized producers who supplied them with important parts. Although stressing the significance of small firms, the report does not minimize the advantages of mass production. It concludes that there is an important place for both types in our national economy, and that small business and big business are really so supplementary in character that they can live harmoniously together—truly a modern economic fable of the lion and the mouse.

22–14. Horizontal and Vertical Combination. Horizontal combination brings together under a single management several plants engaged in the same manufacturing process or commercial venture. Vertical combination, on the other hand, unifies production of goods in a continuous industrial process. Vertical combination or control of a good throughout its various stages from raw materials to finished product is often referred to as the integration of industry.

Horizontal combination can be illustrated by chain stores or by the combination of several creameries. Vertical combination is represented by the combination of a coal mine, a blast furnace, and perhaps a steel-rail manufacturing plant.

Horizontal combination offers the advantages of unified management and such economies in distribution as the elimination of cross freights. Vertical combination possesses the additional advantages of easy access both to raw materials and to markets for finished goods.

Large-scale management has been accomplished by means of horizontal combination, vertical combination, or both. It has developed in manufacturing and marketing organizations. Indeed, it has tended to unite these two activities. Thus, chain stores have gone into baking and canning operations, instead of buying bread and preserves from independent manufacturers.

Whether the natural result of industrial evolution or the artificial creation of human strategy, the final stage has often been that of complete or partial monopoly. Sufficient control over supply has been achieved to influence price by raising it above the competitive level of cost of production.

22–15. Devices Used to Secure Concentrated Control. The history of industrial monopoly shows that it has taken several different forms. When public opinion felt that the trust was safely gripped in the Herculean arm of regulatory legislation, this "Old Man of the Sea" assumed another aspect, and the legal battle began again. Although the evolution of concentrated control did not go through the same processes in all industries, and, where it did, these steps were neither identical nor simultaneous, certain well-defined stages of development can be outlined.

Informal price agreements were, in general, the first form of industrial monopoly. Pools were often organized for the regulation of prices by a

restriction of output, a division of business, and other devices. The use of the trusteeship for concentrated control was another monopolistic device. The holding company was the next step in many industries. The following stage was often that of a merger or consolidation, which resulted in the formation of a single giant corporation. This is perhaps the climax of our industrial drama.

After the dissolution of some trusts was required by the courts, concentrated control was sometimes continued by means of interlocking directorates; *i.e.*, a few influential individuals served as directors in several "competing" companies. Many wealthy investors had bought large holdings of stock in several different companies. Thus, a community of financial interests and a continuity of corporate policy were maintained; competition was not restored immediately or completely.

Behind these various forms of concentrated control were certain dominating spirits who became the great captains of American industry. The romance of early American life was that of the frontier and the conquest of a continent, out of which came patriarchal plantations in the South and imperial ranches in the West. The romance of later American life, played in the big cities, was that of high finance and the achievement of huge fortunes by concentrated control over basic industries. This was the era of railroad empires, steel barons, and oil kings. In our Colonial era and plantation economy, Indians had been exterminated and Negroes exploited; in this later period of industrialization, foreign immigrants, small enterprisers, innocent investors, and the consuming public were victims. The requirements for success were somewhat similar, namely, courage, imagination, and ruthless individualism.

22–16. Pools and Informal Price Agreements. *a. Nature of Pools.* A pool is an arrangement by which "competing" producers can cooperate with respect to prices and trade practices without sacrifice of their individual existence. Unity of action is achieved without actual combination. A pool of some sort was the earliest and most common device for the restriction of competition. It is a blanket term, for it includes various sorts of informal agreements as to prices, output, sales, territory, and patent rights. The cartel is the modern equivalent of the earlier term "pool." It has survived the era of "trust busting" and has expanded to international proportions.

b. Types of Pool. The "gentlemen's agreement" is perhaps the simplest and loosest form of pool. It is an informal understanding as to price or output without a written agreement. Such pools were common in the early history of the iron and steel industry. The famous Gary dinners, for example, were "social affairs" for those interested in the steel business. "Independent" and "competing" manufacturers rubbed elbows around the festive board in such a friendly manner that the new price schedules, which

appeared shortly after these love feasts, agreed in most important points. Little steel companies, which followed the leadership of Big Steel, were permitted survival and given substantial business leavings from the head table. Division of territory, as well as agreement on price, was effected by what was known as the "Pittsburgh plus" system of computing transportation charges on steel products shipped from other and nearer points. This plan for fixing prices was imitated by many cement companies.

A similar type of pool is one in which the parties agree on a limitation of output and divide it among themselves according to some prearranged scheme. Such a restriction of production raises or maintains prices. Pools for restraining output and sharing business were said to have existed formerly among the "Big Five" meat packers.

Another common form of pool has been the patent pool. In the early history of the electrical industry, for example, the General Electric Company and the Westinghouse Company entered into a pooling agreement for the joint use of many patents. Since then governmental prosecutions have been frequent against alleged patent pools in the electrical and chemical industries. Some cartels were alleged to have been international in scope and to have provided joint use of "secret" processes by both American and German firms.

Pools have sometimes been mere selling agencies. Independent manufacturers turned over their products, often by quotas, to a central marketing bureau. Wastes of competition were avoided and expenses of marketing were reduced, but the gains of individual enterprise in production were retained. This sort of combination, permissible in Germany, was long illegal for American firms except for foreign exportation.

Nevertheless, marketing cooperatives in the United States have been permitted not only to sell farm products at controlled prices through central agencies but also to restrict their production by enforcing quota limitations. Apparently, competition in industry is desirable, but competition in agriculture is undesirable. The manufacturer, who can control his output more easily than the farmer, is therefore more apt to restrict production. Again, cooperation is good, but collusion is bad, even though both result in price maintenance.

c. Limitations of Pools. Pools have been neither permanent nor stable. Old pools were frequently replaced by new ones. Their unwritten agreements were conspiracies and not contracts. As they were at variance with the law, pools could not be enforced in court. "Chiselers" secretly lowered their prices or made special concessions to get business away from competitors with whom they had made "gentlemen's agreements" to maintain prices, to restrict production, or to limit their marketing areas. In periods of depression, pools were unable to weather storms of deflation; in crises they could not withstand the sudden squall of price cuts.

d. Success of Pools. Pools have been most common in businesses requiring so much capital that competition could not arise rapidly. Again, they have been most successful with a relatively small number of concerns of about the same size and strength. When any one concern was much larger than the other members of a pool, it ultimately devoured them.

Successful pools necessitated a shrewd policy on the part of their members, as well as loyalty to their agreements. A great or sudden restriction of output always raised prices and often increased profits, so that it resulted in consumers' resistance and a revival of competition. It also invited governmental investigation and prosecution.

22–17. Trusteeship Device. The instability of pools and the difficulty of enforcing their agreements led to a search for a more effective device to secure concentrated control. This was found in the trusteeship, which was often the next stage in the evolution of industrial monopolies. The clipping of the word trustee gave rise to the epithet "trust."

a. Origin and Nature. The first notable resort to this device was made in 1879 by the Standard Oil Company. John D. Rockefeller and his associates acquired controlling interests in many formerly independent oil companies. This "trust" agreement, revised in 1882, included about forty companies, representing over 90 per cent of the capacity of all refining plants then operating in this country. Trustees received from most stockholders of the companies concerned an assignment of their stock with voting power. These cooperating stockholders were given, in return, "trust certificates" of equivalent amounts, representing proportionate shares of the joint venture. Trustees did not become owners of the stock, which they merely held in trust. Nevertheless, they secured control of the subordinated corporations, whose policies were unified and whose profits were pooled. The stockholder lost his claim on the earnings of his particular company and secured instead a proportionate part of the total earnings of all companies included in the arrangement. Trustees might extend their control still further by the purchase of stock in independent companies out of the undistributed profits of controlled companies.

The success of the trusteeship in the oil industry resulted in the prompt formation of similar trusteeships in other fields. The American Cotton Oil Trust was formed in 1884, the National Linseed Oil Trust in 1885, and the Whiskey Trust in 1887. Other important oil companies, the survivors of many years of keen competition, representing about three-quarters of the total refining capacity of the country, made in 1887 another and still broader "trust" agreement in the petroleum industry. These trustees acquired the 20 refineries of the 17 member companies; they soon eliminated 12 refineries and later consolidated the remaining 8 to 4. Economics of large-scale management were supplemented by restriction of production and upward stabilization of price.

b. Legal Opposition to Trusts. Popular indignation against these trusts was expressed first in state legislation, but most of it proved to be futile. The national Congress, therefore, in 1890, passed the Sherman Anti-trust Act, which forbade "every contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade." This law will be discussed in the following chapter.

Unlike informal price agreements and secret pools, "trusts" involved written agreements; hence, they could be reached by the law. Indeed, these trusteeships had hardly begun their operations before legal proceedings were instituted against them. The Circuit Court of Appeals [1] of New York State rendered an opinion in 1890 against the North River Sugar Refining Company. It ruled that it had given over its powers to an irresponsible board—an act that was a perversion of its charter. It had also helped to create a "trust," which was a partnership of separate corporations, and therefore illegal. Other similar court decisions held that such use of the trusteeship was illegal under both common and statute law. After long and tortuous litigation, the Standard Oil Company was finally forced to abandon the device that it had originated.

22–18. Holding Companies. *a. Nature.* The term "holding company" is applied to a security-owning corporation, as contrasted with an operating company. A holding company acquires all or most of the stock of its subsidiary companies, either by cash purchase or exchange of stock. The only important changes involved were the substitution of a corporation for an unincorporated trusteeship, with actual ownership of shares of stock by the holding company instead of indirect control through a fiduciary arrangement, and, finally, the substitution of a corporate board of directors for individual trustees.

b. Origin. Holding companies were originally few in number; they were creatures of special legislation. The Pennsylvania Railroad Company, for example, was especially empowered to buy, to hold, and to sell the securities of certain other companies in order to unify affiliated lines into a trunk system. The Philadelphia and Reading Railroad likewise had been permitted to utilize this device to secure control of the stock of its affiliated mining companies. Although holding companies were not illegal under the laws of most states, special legal action was generally necessary for their incorporation. No state had as yet passed a general law permitting corporations to own, to buy, and to sell the securities of other corporations.

The state of New Jersey, however, amended its corporation laws in 1889 and 1893 by blanket provisions for the legalization of holding companies. A holding company, a legal person, could now own the stock of other corporations without special legislative action. It could receive earnings of subsidiary or operating companies and then distribute them as its own

[1] 121 New York Reports 582.

dividends. A holding company might operate, as well as own, a corporate business; it might supervise subsidiary corporations or merely purchase their securities.

The way was thus opened toward concentrated control by this new device of the holding company. The business of a holding company chartered in the hospitable state of New Jersey might extend anywhere within the United States. This opportunity was soon seized upon by many industries. As charters of incorporations are sources of taxation, other states followed the example of New Jersey by liberalizing their corporation laws to permit the formation of holding companies. Even if no such action had been taken, the result would have been similar, for, as explained in Chap. III, corporations chartered in one state can transact business in all other states, if they observe their respective laws.

c. *Advantages.* The holding company is a device by which concentrated control over much capital and many business organizations can be secured with relatively small funds. A holding company can secure a directing influence or the controlling interest in several corporations by buying blocks of their common stock with only the same amount of money required to buy all the property of any one of them. The fact that bondholders cannot vote and that many small stockholders do not vote gives concentrated ownership of the stock of several related corporations the control over a large amount of corporate capital with a decisive influence on important corporate policies. Even an organized minority often gets its own way in the midst of ignorance, indifference, and indecision.

The flexibility of the holding company is another of its advantages. Through the preservation or creation of local operating companies in various states, compliance with divergent state laws is rendered less difficult. Although the gains of monopoly are achieved, "independent" companies can preserve their own firm names, franchises, and good will.

d. *Dangers.* Although the holding company possesses these, and other, economic advantages, it also presents certain social dangers. It is an artificial device representing financial wheels within wheels. The holding company permits the pyramiding of financial interests and the concentration of control. The rights of independent stockholders in subsidiary companies are often ignored, as the company's policy is determined by the interests of the group in control. The device of the holding company accentuates the general corporate problem of absentee capitalism and further intensifies the separation of ownership from control. The existence of puppet companies makes easier manipulation of securities and evasion of the law; it often serves to conceal the existence of monopoly.

22–19. Merger or Consolidation into a Single Giant Corporation. Holding companies were sometimes permanent organizations, but often they were mere transitional stages in the formation of a single giant corporation. In

some cases, the holding company continued to secure the stock of its subsidiaries to such an extent that it passed from partial to complete ownership. A reorganization then generally took place that substituted one giant corporation for a system of allied companies.

Single giant corporations sometimes evolved without passing through the holding-company stage. When the trustee device was declared illegal, the member corporations of such organizations often decided to unite instead of reverting to their original independence or resorting to another subterfuge for cooperative action. Such combination into a single giant corporation was effected by the purchase and sale of the tangible wealth or securities of one corporation by another. It was achieved also by an exchange of the physical assets or securities of one company for the stock of another.

Combination can take the form either of merger or of consolidation. A merger is the absorption of one weak company or several small companies by a stronger or larger company. A consolidation is the union of two or more companies into another and larger corporation. A merger can be expressed as follows: $a + b = A$. A consolidation would be formulated thus: $a + b = c$.

Overcapitalization was common in this process of reorganization; the total par value of the securities of the new company often exceeded the total value of its tangible assets and the combined capitalization of the original companies. Indeed, a motive for the change from the convenient device of holding and operating companies to a single giant corporation sometimes lay in the desire to capitalize anticipated monopoly profits by the issuance of additional stock without proportionately increased tangible assets.

Nevertheless, the formation of a single corporation in place of a system of holding and operating companies simplified the financial structure. It resulted in the substitution of a corporation owning tangible wealth for a corporation owning the securities of many operating companies. It moved from the stage of confused corporate feudalism to the state of unified corporate imperialism.

22–20. Monopoly and Competitive Prices. Excessive prices, exorbitant profits, and unfair practices have been the three P's in the economic pod of monopoly. Let us examine, in turn, each of these related aspects of the trust problem.

Monopoly price is that which yields the greatest net profits. Competitive price, on the contrary, approximates costs of production, for the gain spirit ultimately attracts other producers into a profitable industry. As the supply of that commodity or service is thus increased, its price tends to fall.

Although monopoly price is apt to be higher than a comparable competitive price, it may be very little higher. Trusts may find that greater

net profits can be secured by a large volume of output readily sold at a low price than by a smaller volume of output restricted by more limited sales at a higher price. If the monopolized commodity or service is a necessity of life, however, the consumer has little opportunity to substitute something else or to refrain from purchasing it. Nevertheless, elasticity of demand would curtail consumption at higher prices, and overhead costs per unit of production would rise with decreased output. These are important factors in curbing monopoly prices.

Although higher than a comparable competitive price, monopoly price is apt to be more stable. By its very definition, a monopoly possesses power to regulate the supply placed on the market. The fluctuations of a competitive price are due, in part, to constantly changing conditions of supply produced by many small, independent enterprisers. By its adjustment of the supply of a controlled commodity or service, the monopoly stabilizes its price, although the process of stabilization is often upward to a higher price level than would prevail under competition.

Moreover, such price maintenance by monopolistic concerns, in the face of a declining demand in periods of business recession, tends to retard recovery and to increase unemployment; it adds to the rigidity of our economy by restricting output unduly in order to maintain artificially some prices while others are naturally adjusted downward by changes in supply and demand forces. Under active competition, on the contrary, prices tend to decline freely during periods of business recession. High-cost producers, who cannot readjust their costs downward, fail; on the other hand, more progressive firms improve their techniques of production to lower cost levels and expand their markets by a reduction in the prices of their products, and so remain in business. But monopoly control often leads to decreased production in order to maintain price in a falling market, instead of production maintenance by price reduction.

22–21. Limitations on Monopoly Price. There are social as well as economic bounds and artificial as well as natural limits to the power of monopoly. These limitations are represented by governmental interference. Such coercive action is exemplified by the state's attempt to dissolve a monopoly or to eliminate unfair methods of competition. Price fixing is the public's "gun behind the door," or its weapon of last resort.

Natural or economic limitations on monopoly have just been illustrated by the power of substitution by consumers, the pressure of overhead costs toward volume production, and the possibility of competition by producers. An exorbitant price may result in a buyers' strike, and mass production requires mass consumption. High prices with huge profits revive competition, as can be seen in those industries in which competition and monopoly have alternated.

22–22. Dumping. Large industries operate under the principle of indirect costs. They have great "overhead," or fixed expenses, such as taxes, interest payments, costs of maintenance, and the like, which vary little whether the plant is running full time, part time, or not at all. In order to spread their huge overhead costs over a large volume of output, and thus reduce per-unit costs, large-scale industries have sought to produce continuously at maximum capacity. By so doing, a surplus has been created that the home market could not absorb without lowering here its monopoly price.

Although monopolies have maintained domestic prices by not flooding the home market with unrestrained production, they have not been so scrupulous about foreign markets. American trusts sometimes employed the device of "dumping" their surplus products on European countries at any price above "out-of-pocket" costs. Lower prices often prevailed abroad because of foreign competition that the American tariff excluded in the home market. Monopoly power permitted the concern to load its total overhead costs on the price charged in the domestic market, while selling the same product in the foreign market for the best price obtainable.

The test of dumping then is a price differential between domestic and foreign markets with the lower price abroad for the same commodity. The foreign price is manipulated between a minimum of direct costs of production at home, to make it profitable to manufacture the excess supply of the good, and a maximum of competitive prices in the foreign market, to make it possible to sell it there. Contributing factors to dumping are monopoly, a protective tariff, and mass production.

22–23. Monopoly Profits. The profits of many American trusts were excessive in amount and concentrated in character. Although smaller investors participated, the lion's share generally went to promoters and manipulators.

An early example was the American Tobacco Company, organized in 1890 by five leading manufacturers of cigarettes. The original capitalization of the company was 25 million dollars of which 15 million dollars represented common and the remaining 10 million dollars preferred stock. The report of the Commissioner of Corporations on the tobacco industry showed that the total value of all the assets acquired, good will included, did not exceed $14,400,000. Thus, there was overcapitalization at the very outset by the addition of nearly one-half "water." Nevertheless, establishment of monopoly control made it possible almost immediately for this company to earn 20 per cent on its common stock, after paying generous dividends on its preferred stock and the stipulated interest charges on its bonds and notes.

Enormous promoters' profits were realized also in the formation of the United States Steel Corporation and the American Can Company. Re-

ports of the former Commissioner of Corporations on various early trusts reveal numerous similar cases. Many large fortunes were made a generation or two ago by the successful promotion of monopolies in many of our basic industries.

22–24. Unfair Methods of Competition. Monopoly is a problem not only of the consumer, but also of the producer. In addition to excessive prices and exorbitant profits, another frequent charge against the trusts was that of unfair methods of competition. It was contended that they cut prices in local markets where competition prevailed, while maintaining higher prices in markets where there was no competition. Hence, the small competitor, like the helpless consumer, suffered at the hands of the trusts.

In 1901 the United States Industrial Commission made the first comprehensive study of wholesale and retail prices paid in different parts of the country for various goods. With regard to petroleum products, the Commission's report contended that the former Standard Oil Company had charged different prices for the same product in different places, the local price depending on the degree of competition. This practice appeared to be common also in many other industries, where it was often regarded as legitimate. It was further contended that some trusts influenced local dealers to boycott competing products in favor of their own. Finally, there was the allegation of discriminatory railroad rates, by which the large shipper was favored at the expense of the small one.

22–25. Trusts, Tariffs, and Lobbies. Another charge was that the trusts fostered tariff legislation, and, in turn, that the tariff was the "mother of trusts." High duties permitted a margin of profit to domestic producers that encouraged a multiplication of plants. Trusts were formed to escape the ruinous competition that otherwise would have followed. These vested interests then sought immunity from foreign competition by still higher duties.

Although many trusts were favored by our high protective tariff, without which some of them would not have developed, other trusts prospered without tariff protection. The Standard Oil Company, for illustration, grew up in an unprotected industry. Again, Great Britain, which formerly had no high protective tariff, experienced a similar but smaller development of monopolies.

Finally, it was charged that trusts had a corrupting influence on our political life. Attempts at their dissolution or regulation were met with legislative intrigue and political chicanery. Trusts were pictured as the "power behind the throne" in the "invisible empire" of big business.

22–26. Advantages of Monopoly. In spite of their great power and bad practices, the trusts achieved certain economies in production. As we shall see later, these advantages of natural monopolies of organization were so great that competition therein was eliminated, and public utilities were

made legal monopolies. Trusts, or industrial monopolies, possess similar advantages, to a smaller degree. In the main, they are the extended economies of large-scale production and the reduced wastes of competition.

Duplication of equipment and effort are eliminated by consolidation. The huge expenses of traveling salesmen and competitive advertising are reduced. Economies of marketing are achieved by an elimination of cross freights necessary under a competitive regime. Economies in buying also can be had by taking advantage of the lower prices that result from purchasing in great quantities. Finally, monopolies can better adjust the output of their plants to the irregularities of market demand than can competitive industries. Hence a monopoly price is more stable than a corresponding competitive price, although at times to the detriment of society, as just indicated.

22–27. Is Monopoly Inevitable? It has been argued that a trend toward monopoly is inevitable in an industry that operates under the principle of indirect costs. In such industries, extensive investment of capital creates great "overhead" or fixed charges, such as regularly recurring interest payments and necessary costs of capital maintenance or replacement. Quantity production per plant is necessary to decrease indirect costs per unit of product. Duplication of plants and equipment is ruinous. The obvious conclusion, therefore, is that competition is undesirable and monopoly is economical.

Socialists claim to see this principle of indirect costs in most modern industries because of the huge amount of capital now necessary in large-scale production. For this reason, they regard big and basic manufacturers as natural monopolies of organization. As private monopoly is socially undesirable, their answer is governmental ownership and operation of all fundamental industries.

Is it not, however, somewhat of an assumption to say that most manufacturing industries are those of decreasing cost? Even so, does this principle continue to operate indefinitely as the size of the industry increases? Cannot large-scale manufacture and large-scale management be carried beyond the point of maximum efficiency or the optimum of lowest average costs?

Many surveys, as previously indicated, testify to the survival power of small enterprises under conditions of fair competition. The continued substitution of electricity for steam power may result in the further decentralization and relocation of our lighter industries. Popularization of the automobile has already created suburbs and stimulated a flight from the city. The future may witness a revival of small industry, as well as the survival of little business. Fear of the atomic bomb, we reiterate, may decentralize heavy and strategic industries; it may also redistribute great population centers.

22–28. Limits and Dangers of Expansion. As there are limits to the managerial capacity of most individuals, so there may well be limits to the size of many industries. Great geniuses of organization, such as Andrew Carnegie and Henry Ford, are rare. Again, the burden of highly centralized administrative bureaucracy, whether corporate or governmental, may counterbalance the economic advantages of large-scale production. The point of maximum efficiency varies in different industries, but combination beyond this point spells loss of efficiency. It is claimed that this very thing has happened today in many trusts. From an economic point of view they have been likened to the famous colossus with feet of clay.

The possession of enormous capital has made it possible for some monopolies to stifle their competitors. They have retarded economic progress although they may well have reduced the wastes of competition. Trusts do not necessarily represent the fittest form of industrial organization merely because they have been successful in the economic struggle for existence; methods employed and conditions of competition must be considered.

22–29. Productive Efficiency versus Pecuniary Strategy. Attempts have been made to differentiate between those monopolies which rest on productive efficiency and those which gain through superior bargaining power. Such a distinction between natural and artificial monopolies is important, but difficult to maintain. It is clear, nevertheless, that many American trusts reached their powerful position more by unfair methods of competition than by improved processes of production and better quality of output.

Some trusts are artificial monopolies created by the financial strategy and economic profiteering of a few dominant personalities. Colossal fortunes and glaring concentration of wealth resulted from these combinations. A plutocracy perpetuated by inheritance of property is as undesirable as an aristocracy of birth, and an economic despotism is as dangerous as a political dictatorship. The achievement or maintenance of industrial democracy is our present problem, as political democracy was the great issue in the last century.

22–30. Summary of Central Issues. The problem of monopoly presents the economic threats of excessive prices, exorbitant profits, and unfair practices. It also holds the political menace of corruption by the vested interests. On the other hand, monopoly secures the economies of mass production, including those of large-scale manufacturing, marketing, and administering big business. Monopoly possesses the dubious advantage of stabilizing prices. It presents the doubtful possibility of living cooperatively with small, competitive firms in the same industry without either dominating or devouring them.

A program of social control suggests three methods of governmental action toward industrial monopolies, namely, dissolution, regulation, or

socialization. Is it possible to break up the trusts? If so, is such a policy socially desirable? If not, then a choice must be made between governmental regulation, criticized as paternalism, or governmental ownership and operation, stigmatized as socialism. The next chapter will review the development of governmental regulation of industrial monopolies or the trusts. Chapter XXIV will then treat public utilities, which are natural or legal monopolies; the controversial issue of governmental ownership and operation will there be analyzed.

Guide Questions on Text

1. Distinguish monopoly from monopsony.
2. Differentiate among monopoly, duopoly, and oligopoly.
3. Define perfect and imperfect competition.
4. What is the test of monopoly or monopsony?
5. Distinguish between the old and the new concept of monopoly.
6. Classify different types of monopoly.
7. Outline social and economic limitations on monopoly.
8. Contrast alleged advantages and disadvantages of monopoly.
9. Outline stages in industrial combination and distinguish between vertical and horizontal combination.
10. Explain important devices used to secure concentrated control.
11. Explain dumping as a problem of indirect costs.
12. Distinguish among large-scale manufacturing, marketing, and administering enterprises. (*Cf.* Chap. III.)
13. Explain pools, giving advantages and disadvantages.
14. Distinguish between trusteeship and holding company.
15. Differentiate between mergers and consolidations.
16. Explain nature and significance of corners.
17. What is overcapitalization? How did it take place in the formation of trusts?

Topics for Investigation

1. Great industrial combinations formed in the United States in the closing years of the last century and the opening years of the present century.
2. Recent industrial combinations.
3. A case history of some great industrial corporation.
4. Big business in the First and Second World Wars.
5. Present outlook for small business.
6. The holding company as a device for securing concentrated control.
7. Illustrations of unfair trade practices.
8. The original trusts.

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CHAPTER XXIII

REGULATION OF THE TRUSTS

23–1. Beginnings of Regulation. Industrial concentration had made considerable progress before public opinion on that subject was aroused. It was years later before regulatory legislation was passed. The organization of effective administrative machinery came still later.

Some laws were vague and others were conflicting. Court decisions were delayed and dubious; sometimes they were altered and even reversed. Constitutional guarantees of property and due process of law presented legal obstacles to effective regulation of the trusts. The federal character of our government prevented centralization of control and uniformity of action.

For generations the common law had opposed monopolies and favored freedom of competition. Statute laws also forbade monopolies, but legislators had in mind the older type of monopoly. It took time to broaden the legal concept of monopoly from a governmental grant to an industrial combination. Meanwhile social policy shifted from public indifference to attempted dissolution, and then to reasonable regulation with the further possibility of gradual nationalization. But the general trend has been from less to more governmental control and from state to Federal authority.

23–2. State Antitrust Laws. State antitrust laws appeared before Federal legislation on that subject. An early Kansas law of 1889 was typical. It forbade agreements, trusts, or combinations to prevent full and free competition. Penalties of fines and even imprisonment were provided for violations. By 1894, a score of states had passed similar antitrust legislation.

These attempts of individual states to cope with big business were futile. Uniform legislation in all states was impossible. State regulation was further hampered by the fact that a trust could incorporate in a state whose laws were lenient and then do business in other states. Control of the trusts finally became a national issue.

23–3. Constitutional Basis of Federal Regulation. Federal regulation of trusts presented the legal question of the constitutional powers of Congress. Like many other industrial problems, it involved a conflict of authority between the Federal and state governments.

The Constitution declares that Congress shall have power to "regulate commerce with foreign nations and among the several states and with the

Indian tribes." [1] This sentence is the legal rock on which rests Federal regulation of business, including trusts, public utilities, and railroads.

Judicial interpretation of the word "commerce" has been broad enough to include both transportation and communication. Chief Justice Marshall, as early as 1827, declared commerce to be all intercourse.[2] The legal status of later inventions, such as the railroad and the telegraph, was thus defined before they had come into existence.

The Supreme Court has held that interstate commerce includes not only the transportation of commodities but also their purchase, sale, and exchange. On the other hand, it declared that commerce did not include manufacture; industry changes the form, but commerce the place, of goods.[3]

This distinction between commerce and industry, like that between interstate and intrastate commerce, is of less importance now than formerly. Every large manufacturing concern is obliged to import its raw materials from other states and to ship its finished goods outside its own state borders. Hence, it must engage in interstate commerce. It is safe to say, therefore, that almost every large industry is subject in some degree to the interstate-commerce regulations of Congress. This broad construction of the interstate commerce power has been expressed in recent decisions of the Supreme Court supporting the Fair Labor Standards Act of 1938.[4]

23-4. Interstate Commerce Act. At first, trusts were regarded as closely related to railroads; their origin was sought in railroad discriminations and rebates. Hence, the Interstate Commerce Act of 1887 may be viewed indirectly as a trust measure. A discussion of this law, however, will be reserved for a later chapter on the railroads, where it more properly belongs. The first Federal law devoted specifically to the trusts was the Sherman Anti-trust Act of 1890, with which our present survey begins.

23-5. Sherman Anti-trust Act. *a. Contents.* The Sherman Anti-trust Act of 1890 was entitled "An act to protect trade and commerce against unlawful restraints and monopolies."

The first two sections of this law are of sufficient importance to quote.

> Every contract, combination in the form of trust or otherwise, or conspiracy in restraint of trade or commerce among the several States, or with foreign nations, is hereby declared to be illegal. Every person, who shall make such a contract or engage in any such combination or conspiracy, shall be deemed guilty of a misdemeanor, and, on conviction thereof, shall be punished by fine not exceeding five

[1] Art. I, Sec. 9.

[2] *Brown v. Maryland,* 12 Wheaton 419 (1827).

[3] *E. C. Knight Sugar Refining Co. v. United States,* 156 U.S. 1 (1895).

[4] *United States v. Darby,* 61 S. Ct. 451 (1941); and *Opp Cotton Mills, Inc. et al. v. Administrator of Wage and Hour Division of Department of Labor,* 61 S. Ct. 525 (1941).

thousand dollars, or by imprisonment not exceeding one year, or by both said punishments, in the discretion of the court.

Every person who shall monopolize, or attempt to monopolize, or combine or conspire with any other person or persons, to monopolize any part of the trade or commerce among the several States, or with foreign nations, shall be deemed guilty of a misdemeanor, and, on conviction thereof, shall be punished by fine not exceeding five thousand dollars, or by imprisonment not exceeding one year, or by both said punishments, in the discretion of the court.

Later sections give the circuit courts of the United States jurisdiction to enforce the law, and provide that the Federal government itself may institute proceedings in equity to prevent and restrain violations thereof. They confer upon persons injured by trusts the right to sue the offending party for triple damages and the cost of the suit. Finally, they construe the word "person" to include corporations and associations.

b. Early Judicial Interpretation. For some years after its passage, the Sherman Anti-trust Act remained almost a dead letter. This was due in large part to the vague wording of its sweeping denunciations and strong prohibitions. The law gave few definitions; it made little differentiation among various kinds of combinations. Doubt existed as to the exact meaning and legal significance of important provisions of this statute.

Its effectiveness was impaired also by an interpretation of the Supreme Court that the Sherman Act applied to commerce but not to manufacture. Moreover, a combination was not viewed as a violation of law unless it attempted to monopolize interstate commerce. This Supreme Court decision in the case of the Knight Sugar Refining Company,[1] in 1895, was commonly construed as a judicial confession of the weakness of the Sherman Act in particular and of Federal regulation of trusts in general. Intrastate manufacturers were apparently exempt from its provisions.

c. Status of Holding Companies under the Sherman Act. This issue was presented by the Northern Securities Company, which was essentially a combination of the Great Northern and the Northern Pacific Railroads. The Supreme Court [2] in 1904 ordered the dissolution of this holding company as a combination in restraint of trade. Like the earlier device of the trusteeship, the holding company was held to be illegal when used for such improper purpose. Although a natural monopoly and not a business combination, the railroad was still regarded as a competitive industry.

d. Rule of Reason. The Standard Oil Company of New Jersey also was a holding company that owned stock control of subsidiary corporations. In 1906, a government suit was brought against this combination as a violation of the Sherman Act. The Circuit Court held the company to be a combination in restraint of trade, but the case was appealed. In 1911, a

[1] *E. C. Knight Sugar Refining Co. v. United States*, 156 U.S. 1 (1895).
[2] *Northern Securities Co. v. United States*, 193 U.S. 197 (1904).

Supreme Court[1] decision upheld the lower courts and ordered the dissolution of this holding company.

The Standard Oil decision was of special significance because it introduced the adjective "reasonable" into its discussion. The Court declared that the mere existence of a combination was not sufficient ground for indictment; there must be evidence of conspiracy to restrain trade. Moreover, the courts should consider, "in the light of reason," whether the combination is using illegitimate means to take business away from its competitors, or whether it is merely striving to secure economies of large-scale production.

The Supreme Court rendered in the same year a similar decision[2] against the American Tobacco Company. Although it ordered a reorganization of the corporations involved in this combination, the Court again went on record as not hostile to combination for greater productive efficiency.

These decisions of 1911 forbade the formation or continuance of destructive or extortionate combinations, whose purpose it was to eliminate competition by unfair means and to raise prices to exorbitant levels. The question no longer was simply whether a combination in restraint of trade existed. It was broadened to consider whether the economic aims and effects of such a combination were good or bad. Hence, these two decisions have been said to inaugurate a "rule of reason" by the Supreme Court.

e. Legal Status of Corners. Judicial interpretation of the Sherman Act held that it was applicable to "corners,"[3] The Court contended that the widespread purchase of an article for the purpose of withdrawing it from trade, in order artificially to increase its price, was restraint of trade within the meaning of the Sherman Act. It was unlikely that a speculator could corner the cotton market without restricting interstate commerce, even if his purchases were confined to one state.

f. Legal Status of Trade Unions. A further issue raised by the Sherman Act was its effect on organized labor as well as on capitalistic combinations. Was a trade union a combination in restraint of trade? If so, the Sherman Act would sound the death knell to almost a century of labor organization. In spite of this possibility, judicial decision was that such a view was not the intent of the law. Nevertheless, the courts did find certain practices of unions such as secondary boycotts and mass picketing to be conspiracies in restraint of trade. They will be discussed in later chapters on industrial relations.

g. Nature and Purpose of the Sherman Act. The Sherman Act was a general statute declaratory of a broad public policy. It must be judged by

[1] *Standard Oil Co. v. United States*, 221 U.S. 1 (1911).
[2] *United States v. American Tobacco Co.*, 221 U.S. 106 (1911).
[3] *J. A. Patten et al. v. United States*, 226 U.S. 524 (1913).

the soundness of this policy, by the accuracy with which it expressed it, and by the penalties that it provided for violations.

The public policy which the act was intended to embody is that competition should be maintained, artificial monopoly destroyed, and its growth prevented. It is clear from the debates attending its enactment that its hostility towards large industrial combinations was especially directed against (1) their supposed power over prices, and (2) their aggressive suppression of competition. Whatever the economic advantages of monopoly may be, there will be little question of the soundness of the policy which attempts to deprive it of its power for evil in these two particulars.[1]

h. Ambiguous and Punitive Character. The Sherman Act lacked precision of expression. General phrases may have been chosen intentionally by its framers, in order that the application of the law could be left to the courts. This process of judicial interpretation was slow and uncertain, but important and progressive. The language of the statute was inadequate also because of its inclusiveness. The courts were forced eventually to differentiate between reasonable and unreasonable combinations.

The Sherman Act was negative rather than positive in its declaration of public policy. It made few exceptions and distinctions. Its penalties were drastic: threefold damages were to be awarded injured parties. The criminal provisions of the Sherman Act have been almost impossible to enforce because of their severity. In general, fines, but not imprisonment, have been imposed for violations of this statute.

23–6. Dissolution of the Trusts. Because of these inherent defects in the Sherman Act, and because of early judicial interpretations of that law, dissolutions of trusts under it were delayed. Prosecutions were few and feeble during the first decade of its existence.

After assumption of office by President Theodore Roosevelt, vigorous action against the trusts was inaugurated. Among the industrial combinations attacked, as previously noted, were the Standard Oil Company, the American Tobacco Company, the powder trust, and numerous smaller concerns. The Northern Securities Company and other railroad combinations also were assailed.

The process of "trust busting" was continued in the Taft administration, from 1909 to 1913. Suits were brought against the United States Steel Corporation, the American Sugar Refining Company, the International Harvester Company, the United States Shoe Machinery Company, the National Cash Register Company, and many other large concerns.

During President Wilson's first term, the number of new indictments was smaller than in either of the two previous administrations, but the prosecution of suits previously filed was continued. The First World War,

[1] Young, A. A., The Sherman Act and the New Anti-trust Legislation, *Journal of Political Economy*, vol. 23.

however, created new problems, and American interest, as we have seen, shifted from domestic to international issues.

23–7. Economic Effects of Dissolution. The first great industrial combination dissolved under the Sherman Act was the Standard Oil Company. The effects of this dissolution were investigated by the Federal Trade Commission, and described in its "Report on the Price of Gasoline in 1915." Its conclusion was that there was little, if any, immediate restoration of competition among the former subsidiaries of the Standard Oil Company of New Jersey, which "maintained a complete division of territory embracing the whole country and that almost without exception each Standard marketing company occupies and supplies a distinct and arbitrarily bounded territory." Among these various spheres of influence the price of gasoline varied. If competition had prevailed, gasoline would have been shipped from low-price areas to higher price areas, until price differences were leveled to costs of transportation. Although there were then independent companies, such as the Texas Company, the investigation seemed to show that they followed prices fixed by the Standard companies. A community of interest among various Standard companies based on common stockholding seemed to prevail. Leading officers and directors of one company were frequently large stockholders in several related companies. The conclusion of the Commission was that the petroleum industry, as late as the First World War, remained a combination, in fact if not in law, despite technical compliance with the dissolution order.

Subsequent investigations [1] of the oil industry, however, give conclusions differing from those of the Federal Trade Commission's early report. They testify to the existence of competition. If these findings are accurate and typical, they indicate that the dissolution of the trusts by court order can be achieved, but that it is a lengthy and difficult process. On the other hand, natural economic growth, rather than legal prosecution, may have been chiefly responsible for the revival of competition in the petroleum industry.

In general, it would appear that dissolution rarely came early enough to effect the easy and permanent destruction of a monopoly. Competition was not ordinarily restored, because some other means of achieving concentrated control could be found. There was often no other vigorous contender in the field to strive for business. Monopoly had crystallized to such an extent that many of the newly formed companies could not or would not compete. Subsidiary companies, legally restored to independence, did not immediately become independent. It has been facetiously said that efforts to dissolve the trusts were as futile as an attempt to unscramble an omelette into its original and constituent eggs.

[1] Stocking, G. W., "The Oil Industry and the Competitive System," Houghton Mifflin Company, Boston, 1925.

23-8. Industrial Commission and Bureau of Corporations. A temporary Industrial Commission was appointed in 1898 to investigate monopolies. Its report of 1900 recommended more detailed and permanent supervision over industrial corporations.

Congress, therefore, in 1903 established in the Department of Commerce and Labor a Bureau of Corporations, headed by a Commissioner of Corporations, who was authorized to investigate the affairs of corporations engaged in interstate or foreign commerce. Findings of the commission could be made public and legal action might be taken against offending corporations.

23-9. Federal Trade Commission. *a. Organization.* The Federal Trade Commission Act of 1914 provided for the creation of a Federal Trade Commission of five members, to be appointed by the President with the advice and consent of the Senate for a term of seven years. The Commission was designed to be a nonpartisan body; not more than three commissioners might be members of the same political party. After the organization of this Commission and the election of its chairman, the Former Bureau of Corporations and the Office of Commissioner of Corporations ceased to exist. The new body took over the investigations, records, property, funds, and employees of the older body. Like its predecessor, the Federal Trade Commission was an administrative body of economists and accountants who were to investigate cases and to secure factual data. They were to cooperate with lawyers on the staff of the Attorney General in the preparation of cases if prosecution was in order.

b. Aim: Elimination of Unfair Practices. The Commission was directed to prevent persons, partnerships, or corporations (except banks and common carriers, subject to the Federal Reserve Board and the Interstate Commerce Commission respectively) from employing unfair methods of competition. The chief administrative duty of the Federal Trade Commission was the discovery and elimination of these unfair practices.

Unfair methods of competition had been made illegal by the Sherman Act of 1890, but the Federal Trade Commission Act of 1914 was more specific in its definition of them. The following practices were proscribed: (1) price discriminations, (2) exclusive dealers' agreements, (3) obvious imitations of brands not protected by patents or copyrights, and (4) espionage on competitors. Some of these unfair practices were proscribed also by the Clayton Act, a supplementary piece of antitrust legislation passed the same year as the Federal Trade Commission Act of 1914; it will be discussed in the following section.

c. Powers of Investigation and Publicity. The Federal Trade Commission is empowered by law to investigate the organization, business conduct, practices, and management of all corporations engaged in interstate commerce excepting banks and common carriers. It also has the power to make public such information as it deems desirable.

The Federal Trade Commission can exercise its powers of investigation by requiring corporations subject to its control to file with it annual or special reports. There are penalties for failure to make returns and for false statements.

Favorable action or inaction by the Federal Trade Commission, known as an "immunity bath," generally avoids suit brought by the Department of Justice. Disclosure of unfavorable data or the threat of prosecution often is sufficient to correct unfair practices of the offending corporation.

d. Procedure. The administrative procedure of the Federal Trade Commission is somewhat as follows: The initiative for investigation may come from Congress, the President, or the Attorney General; the Federal Trade Commission may act on its own initiative, or on the plea of an injured party, supported by evidence. The Commission states its charges and serves notice upon the offending party, which has the right to appear at the proper time and give reasons why the Commission should not issue a restraining order against it.

If the Commission finds the practice to be unfair, it puts the facts in writing and issues an order to the corporation to desist. If the order is not obeyed, the Commission may apply to the Circuit Court of the United States for its enforcement. The court shall then have the power to make an order affirming, modifying, or setting aside the order of the Federal Trade Commission. The findings of the Commission as to the facts, if supported by testimony, are conclusive. The court generally confines itself to a consideration of points of law involved in the case.

A compromise is sometimes reached, and what is known as a "consent decree" may be issued. The Federal government may drop further prosecution and not press its charges. The indicted company, in turn, agrees to abandon specific practices, alleged to be unfair, and/or to modify in an acceptable manner certain practices that are regarded as objectionable by the Federal Trade Commission.

23-10. Clayton Act. The Federal Trade Commission Act of 1914 created new administrative machinery of government. The Clayton Act, passed the same year, may be regarded as an amendment to, or an interpretation of, the earlier Sherman Anti-trust Act. The Clayton Act may be divided into three parts: (1) a set of positive prohibitions against unfair practices, (2) legal remedies for them, and (3) labor provisions. The labor provisions of the Clayton Act, to be discussed in later chapters, sought to legalize boycotts and to limit the use of injunctions in labor disputes.

a. Prohibition of Unfair Practices. Among the practices prohibited by the Clayton Act were price discriminations, tying agreements, holding companies, and interlocking directorates, where the purpose and effect were the creation of monopolies and combinations in restraint of trade.

The act declared it to be unlawful for any person engaged in interstate commerce to disciminate in price between different purchasers of com-

modities, where the effect of such discrimination might be a substantial lessening of competition or a tendency to create a monopoly in some business. A penalty was attached for discrimination, and the enforcement of this provision was placed in the hands of the Federal Trade Commission. Open and honest differentiation in price, based on recognized differences in quality of goods or quantity of lots, was permissible. Such legal differentiation must not be confused with illegal discrimination.

A loophole was left in the law, however, by the proviso that a discrimination "made in good faith to meet competition" should not be construed as a violation of the law. The Clayton Act was subsequently amended in this particular by the passage in 1935 of the Robinson-Patman Act, which was construed as an anti-chain-store bill, but which, in reality, merely sought to enforce the levying of the same price on every customer buying the same quantity and quality of a good under similar conditions of delivery.

Tying agreements include sales based on the condition that the merchant will buy other articles from the same manufacturer or that he will refrain from buying products of competing manufacturers. The Clayton Act was designed to frustrate such exclusive contracts, the effects of which might be to "substantially lessen competition or tend to create a monopoly." This provision, however, has been difficult to enforce. Local dealers willing to limit themselves to a single line of merchandise merely became agents of that particular manufacturer. Other merchants seeking to remain independent and to sell several competing products discovered that they received poorer service and lesser proportions of more desirable items than those merchants who were willing to feature the allied lines of a single manufacturer. A close relationship between manufacturer and dealer could be made effective without a tying agreement.

By the Clayton Act, no corporation engaged in interstate commerce "shall acquire, directly or indirectly, the whole or any part of the stock or any other share capital of another corporation engaged also in commerce, where the effect of such acquisition may be to substantially lessen competition." But the act was not retroactive and provided that nothing in the law should be held to "affect or impair any right heretofore legally acquired." Special exemptions were made for railroads that had used holding companies to expand small lines into trunk systems.

The law further provided that after two years no person should be at the same time a director in two or more corporations engaged in commerce (other than banks and common carriers, for which special legislation was passed), and one which had a capital, surplus, and undivided profits exceeding 1 million dollars, if such corporations are or have been heretofore competitors. Although interlocking directorates were thus prohibited, the law did not prevent an individual or a group of individuals from owning stock in several "competing" companies. It was this community of owner-

ship that made possible the continuance of monopoly after its legal dissolution had taken place. Moreover, this provision of the Clayton Act was circumvented by the subterfuge of dummy directors owning a few shares of stock elected by powerful interests owning many shares of stock, who dictated the votes of the "dummy directors" whom they selected.

b. Legal Remedies for Unfair Practices. The Clayton Act reaffirmed the right, originally granted by the Sherman Act, of a victim of these unfair practices to sue for triple damages in a Federal court. It also improved the legal position of the plaintiff or injured party in several important ways. Suit could now be entered in any district court of the United States, whereas formerly it could be entered only in that district in which the defendant company had been incorporated. Again, the plaintiff could now use old evidence previously established in court concerning the unfair practices of the offending company, which had not been previously allowed.

Moreover, injured parties were permitted to petition the courts for relief by injunction against proscribed unfair practices. An injunction is an order by a court in equity that compels an offending party to perform a required act or to refrain from actions specified as improper by the court decree. Failure to comply with such an injunction or court order implies contempt of court; it may involve loss of right to trial by jury.

The Clayton Act further provided that where a corporation violated any of the penal provisions of the antitrust laws, such a violation should be regarded as the act of the individual officer, director, or agent of the corporation who authorized it. As explained in Chap. III, a corporation is a legal entity, and many individuals had been shifting responsibility for their acts to this intangible person, who might be fined or liquidated, but who could not be sent to jail. The Clayton Act attempted to personalize the direct liability to the officers and directors of a corporation for its unfair practices.

23–11. Recapitulation of Trust Legislation of 1914. The Clayton Act amended the Sherman Act by defining more specifically unfair commercial practices. The Federal Trade Commission was created to suppress the unfair practices of corporations engaged in interstate commerce. A corps of trained investigators was provided to enforce the laws of Congress and the verdicts of the courts.

The trust legislation of 1914 marked the change from negative prohibition to positive regulation. It permitted more individualized treatment, attempting at the same time to remove the trust problem from politics. It relieved the courts of a mass of petty litigation, thus expediting judicial action. It exemplified the recent tendency of governments to utilize economists as well as lawyers.

The law recognized and extended administrative control, by which the general principles of legislation, as interpreted by the courts, would be supplemented by the detailed regulations of an administrative body. It

improved administrative procedure and standardized administrative practices.

The trust legislation of 1914 no longer attempted to enforce competition where cooperation seemed beneficial. It permitted combination where it did not proceed by unfair methods nor result in unsocial consequences. Again, the new attitude was more preventive and less punitive in character. It represented reasonable regulation, rather than blind dissolution. In short, these two so-called "antitrust laws of 1914" sought to crystallize into legal statute and administrative procedure those changes of public attitude and judicial interpretation previously described as the "rule of reason."

23–12. Change in Attitude toward the Trusts. Dissatisfaction with their dissolution engendered popular skepticism, both as to the advisability and the possibility of "trust busting." Public opinion began to contrast the advantages of large-scale production with the wastes of competition. Large business concerns inaugurated a process of public education along these lines. Ruinous competition was shown to be as disastrous as ruthless monopoly was dangerous. Price stability, even when artificially maintained, was pictured as more desirable than the wide swings of competitive prices and the undercutting of costs by price slashes.

The former policy of suppression, as we have seen, gradually turned to one of supervision. "Regulation by the axe" had given way to a "rule of reason," even in dissolution. The "principle of expediency" was now invoked, and regulation was suggested as a substitute for dissolution.

This change of attitude was expressed in an opinion of the Supreme Court regarding the United States Steel Corporation. This time the verdict was against dissolution. After years of litigation the Court finally declared in 1920 that

> We are unable to see that public interest will be served by yielding to the contention of the Government respecting the dissolution of the Company . . . and we do see in a contrary conclusion a risk of injury to the public interest, including a material disturbance of, and, it may be, serious detriment to, the foreign trade.[1]

Wastes of competition were eliminated and unified control of production was sought in times of war. Big business was effectively utilized for the planned production of essential materials. The decade of prosperity after the First World War brought a revival of the consolidation movement. The courts were inclined to the "rule of reason," and even invoked the new "principle of expediency." Indeed, the Republican administrations of Presidents Harding, Coolidge, and Hoover were not unfavorable to big business. Although governmental indictments extended to a member of the Cabinet of President Harding, the prosecution was for fraud and not for a violation of the Sherman Act.

[1] *United States v. United States Steel Corporation,* 251 U.S. 417 (1920).

The great depression of the early thirties brought the reform legislation of President Franklin D. Roosevelt. The codes formulated under the National Industrial Recovery Act of 1933, later declared unconstitutional, were contrary to the spirit of the Sherman Act, as previously shown, because they involved agreements and limitations on production. Thus, the governmental policies of rival administrations in periods of prosperity and depression alike were consistent in that they passed from a stage of hostility to one of tolerance, and then to actual encouragement of combination.

This general economic development, however, has not been continuous, for spasmodic bursts of "trust busting" have interrupted the occasional honeymoons of business and government. Court decisions have been as inconsistent as administrative policies. Finally, our economic attitude at any particular time has been neither clear nor consistent. Governmental action, like that of the mad queen of "Alice in Wonderland," has been consistent only in striking out in all directions at big businesses in general, but it has also been inconsistent in striking out simultaneously in diametrically opposite directions. Government has frowned on combinations of capital, but favored those of labor. It has condoned certain types of cooperatives but condemned combinations, when both often acted similarly to limit production and to maintain prices. Most legislation has been aimed at monopolies, but some, as we shall soon see, has been directed against cut-throat competition.

23–13. Investigation and Administration. Whatever its aim, governmental policy has shifted from a negative or punitive program to a more positive and preventive attitude towards the trusts. With offending corporations, as with individual criminals, reformation and prevention have been increasingly stressed; less emphasis has been placed on prosecution and punishment.

Such an enlightened program necessitated specific definition and detailed interpretation of unfair practices. This involved codification and standardization of corporate practices. Such comprehensive investigation required a research corps of economists and accountants. It was necessary to distinguish between desirable and undesirable practices before the arm of the law could be stretched to give relief from the concentrated power of big business.

An administrative corps of financial experts and field investigators, therefore, was created to get all pertinent facts and to sift the evidence in order to discover if serious violations of antitrust laws had taken place; and, if so, to prepare the case for prosecution by the legal department of government. Even after a court decision had been rendered, such an administrative staff was needed to continue supervision of the questionable corporation in order to make sure that the court orders were enforced.

Governmental progress has been clarified by administrative bureaus, which have expressed in detailed rulings the general policies stated in legal

statutes or court decisions. A body of "administrative law" has thus come into existence. After investigation of their affairs many offending corporations have been let off with admonitions against ignorance of the law or indifference to it. Prosecution has been reserved for willful, flagrant, and repeated violations.

The requirement of investigation and the possibility of subsequent prosecution have generally been sufficient to eliminate gross injustices. In border-line cases, questionable practices have been eliminated by compromise solutions before and after prosecution. The government has often consented to drop its prosecution if the defendant corporation would modify its policy. Decisions have been made that some practices were permissible, but others punishable; still other practices were ordered changed in certain specified respects.

The weapon of publicity has been found to be more effective than was formerly supposed. The revelation of an offensive condition by a thorough investigation on the part of an impartial body of governmental experts often aroused public opinion so that the objectionable practices were voluntarily discontinued by the offending corporation. The possibility of a buyers' strike or the substitution by consumers of one product for another after investigation revealed a bad situation has had the influence of a disinfectant on corporate policies. Big business has become interested in improved public relations.

23–14. Competition in International Trade. During the early part of the twentieth century it was predicted that American trusts would capture the markets of the world. Not many years later the opposite view was expressed, because of vigorous governmental action against these great industrial combinations. Some powerful American corporations may have been strong enough for foreign competition, but many of our smaller concerns, especially in competitive industries, were at a disadvantage.

American manufacturers had to meet the keen rivalry of powerful foreign combinations, which were sometimes international in scope and often aided by their governments. Germany, for illustration, had effectively organized her shipping and banking facilities to promote the sale of her manufactures in foreign ports. Cartels, or cooperative selling associations with powers to regulate prices and pool profits, were permitted under German law.

23–15. Webb-Pomerene Act. *a. Purpose and Provisions.* The Webb-Pomerene Act of 1918 permitted combinations in foreign trade, which were forbidden in interstate commerce. It allowed small companies, not having enough capital or volume of business to conduct export trade single-handed, to combine for this purpose into an export association.

Within a few years after the passage of the act, many such associations had been formed. They now represent a membership of thousands of plants

throughout the United States. They come under the supervision of the Federal Trade Commission, to which body they must make periodic reports.

b. Advantages and Dangers. Overhead charges of such an export association are distributed over its combined foreign sales, thus bringing down marketing costs per unit of product sold and per company participating. Other advantages are: more complete and accurate information about world markets and prospective customers; better facilities for exportation of goods and collection of accounts due; ability to give longer credits, so essential in some export trades; greater ease with which initial losses can be carried; concerted rather than competitive advertising and selling; and, finally, a mutually helpful exchange of ideas among members of the association.

One of the chief objections to the Webb-Pomerene Act is that these export associations may be used for restricting competition in the home market. In spite of prohibitions in the law, the advantages of harmonious action in foreign trade may be carried over into the domestic market. Another possibility is that the Webb-Pomerene Act may promote dangerous international combinations. Even prior to its enactment, there were such organizations for the sale of steel rails, gunpowder, thread, and other products. In spite of the legacy of war hatreds, an international organization was formed shortly after the First World War to coordinate the French and German steel industry. The Second World War revived similar allegations about German-American cartels in the chemical industry.

23-16. Codes under the National Industrial Recovery Act. *a. Background of Ruinous Competition.* During the great depression from 1929 to 1933, described in an earlier chapter on the business cycle, security prices dropped and production was curtailed. In a desperate effort at self-preservation, competing firms cut prices of their products, reduced wages of their workers, resorted to unfair methods of competition, and abandoned customary standards of working conditions and business ethics. The industrial anarchy of the depression was even worse than the industrial despotism of the previous period of prosperity. Ruinous competition became as great a menace to economic welfare as ruthless combination had formerly been. The cutting of wages, slashing of prices, and breaking of agreements were even more flagrant among small enterprises than among large companies. Social standards were threatened more by petty sweaters, "fly-by-night" manufacturers, and operators of "snowbird" mines than by huge corporations in a monopolistic position, which, if anything, sheltered them from fierce competition.

b. Legal Provisions and Administration. As was shown in Chap. X, dealing with business cycles, one of the first fruits of the Roosevelt recovery program was the passage in 1933 of the emergency measure known as the National Industrial Recovery Act. Its primary objects were to increase

employment and purchasing power among the masses of workers. It provided that employees work shorter hours for approximately the same "take-home" earnings at higher wage rates in an effort to maintain their own purchasing power while making work for other employees. Employment for more than the stipulated number of hours or failure to pay the prescribed wage was stigmatized as unfair competition, a new use of that much abused term.

The National Industrial Recovery Act was administered through huge industrial organizations, representing most of their constituent companies, such as "competitive" manufacturers of steel or cotton textiles. Such a trade association drew up its own code, one that became mandatory on all firms therein after a formal hearing and approval by the Federal Code Administrator. In order to expedite the voluntary formulation of codes by industries themselves, the President issued a blanket code for all industries not covered by their own approved codes.

c. *Criticism and Conflict of Policies.* This naive plan of making work was dubious, and this simple policy of maintaining purchasing power was doubtful to students of orthodox economics because commodity prices rose as fast as, or even faster than, money wages. But the new threat of ruinous competition and the changed concept of unfair competition are even more significant for our present purpose than the novel attempt at wage and price stabilization.

Collective efforts to prevent so-called "overproduction" and to maintain prices through agreements to limit production, as we have seen, were not discouraged, but actually encouraged, under the New Deal. The Sherman Act, the Clayton Act, and other pieces of antitrust legislation were declared to be inoperative during the existence of the National Industrial Recovery Administration.

Manufacturers, who complained of rising costs of business, requested the power to raise or to maintain prices in order to assure themselves of reasonable profits. Although the government denied manufacturers the right to fix prices and refused to punish those selling a particular article for less than a certain price, the power to agree collectively on a limitation of production was, in effect, the power to fix prices as long as all producers held to such an agreement. Unlike former pools, which were illegal under the Sherman Act, these agreements within particular industries became legal under codes approved by the National Industrial Recovery Administration. In intent and effect, however, supervised codes and secret pools were strikingly similar.

Associations formed under the Webb-Pomerene Act were permanent marketing cooperatives for foreign export business only. Industrial associations created by the National Industrial Recovery Administration were to operate in the home market merely during the emergency. Their similar objective, however, was the formulation of approved practices and

cooperative policies within particular industries to standardize production and to stabilize prices. Codification of voluntarily agreed upon fair practices and adherence to them were positive actions, regarded as preferable to the former, negative compulsion of the Sherman and Clayton Acts to avoid unfair practices. But the unmistakable trend in both the Webb-Pomerene Act and the National Industrial Recovery Administration was toward cooperation and even toward combination; it was away from conflict and even away from competition. The direction of these two later laws was opposite to that of the earlier Sherman and Clayton Acts, which had sought to enforce competition and to punish combinations.

d. Termination of License Power and Industrial Codes. The National Industrial Recovery Act gave the President the power to compel all industries engaged in interstate commerce to obtain licenses to operate. He could also revoke the license of any concern that violated the code of that industry. By the provisions of the act, this licensing power expired one year after its passage, *i.e.*, June 16, 1934; it was not renewed.

A unanimous Supreme Court decision in the spring of 1935, as previously indicated, terminated the National Recovery Administration. Industrial codes formulated thereunder thus lacked further legal authority and were soon discontinued. NIRA, born of the great depression, had an even shorter life than her British cousin, DORA (Defense of the Realm Act), born of the First World War.

23–17. Federal Controls during the Second World War. The New Deal in the United States was preceded by the great depression; its administration was extended into the Second World War. The wide scope and long duration of this global conflict were expressed in its astronomical costs and in our staggering national debt. These problems were discussed in earlier chapters on public finance. Our present concern is to show that business as usual, which was difficult in the First World War, became impossible in the Second World War.

Cooperation, instead of competition, became the order of the day. Individual enterprise gave way before collective effort and public need. Priorities were imposed on essential materials and services. Procurement was channeled through governmental agencies. Unnecessary occupations were discouraged and luxury goods were discontinued. Some merchants, unable to get such goods as automobiles and refrigerators, went out of business. Manufacturers, both large and small, changed the character of their production from consumption goods to articles of war. The preceding chapter showed how great a proportion of our industrial output for the Second World War was concentrated in a relatively few large business corporations.

In order to secure a fair distribution of scarce consumers' goods and to check the rising spiral of inflation resulting from increased money income with a decrease or disproportionate increase in consumers' goods, the Fed-

eral government resorted to the rationing of scarce commodities and the freezing of their prices by the Office of Price Administration. A policy of wage stabilization also was introduced to curb the mounting costs of production and the consequent rise of prices. The Second World War substituted the threat of a scarcity of goods and monetary inflation for the former depression menace of surplus stocks and monetary deflation. But the significant point is that these two different emergencies produced similar results; namely, increased governmental control over industry, more restrictions on individual enterprise, decreased reliance on the natural forces of supply and demand, and abandonment of the former automatic regulation of production and consumption by market price.

23–18. Price Maintenance. Even before the emergencies of the great depression and the Second World War, there had been growing support for a policy of price maintenance, although it was generally upward price maintenance by business for the stabilization of profits, rather than downward price stabilization by government in the interests of consumers. Some of this support for a policy of price maintenance by business took the form of anti-chain-store bills, especially directed against their policy of price slashing.

a. State Fair-trade Laws. As with antimonopoly legislation, this anticompetition legislation was expressed first in states statutes. Some states passed anti-chain-store laws that placed special taxes or excessive rates of taxation on multiple-outlet merchandising organizations. Other states proscribed as unfair or illegal competition the utilization of loss leaders, *i.e.*, the sale of some commonly used article like sugar at a price below its cost of production or acquisition.

Other state laws were similar in intent, but positive instead of negative in character. They permitted and even protected the price maintenance of advertised brands at their specified prices. In some cases, retailers were forbidden by law or by tying agreements with manufacturers from cutting prices below those advertised or specified. The validity of such state laws for price maintenance was supported by the United States Supreme Court in 1936, when it upheld the Fair Trade Act of Illinois.[1]

b. Federal Miller-Tydings Act. Finally, this policy of price maintenance was recognized by the Miller-Tydings Act, a Federal fair-trade practices law, passed in 1937. This further amendment of the Sherman Act drastically modified its former amendment by the Clayton Act. The Miller-Tydings Act gave Federal sanction to minimum-price agreements on branded or identifiable goods for resale in interstate commerce in those states where such price maintenance agreements were valid under their respective state laws. At that time, such fair-trade acts were in operation in 42 states. Only four of the six remaining states had statutes that spe-

[1] *Old Dearborn Distilling Co. v. Seagram Distilling Corp.*, 299 U.S. 183 (1936).

cifically forbade price-fixing agreements. Obviously, a reversal of state policy had taken place since the early period of drastic state legislation against trusts and price maintenance, which had culminated in the passage of the Sherman Anti-trust Act by the Federal government in 1890.

23–19. Present Dilemma. The present dilemma lies in the fact that one set of laws, such as the Sherman and Clayton Acts, are designated as antitrust laws and designed to maintain competition, whereas another set of laws, illustrated by the Federal Miller-Tydings Act and state fair-trade laws, seek to promote cooperation and to provide price maintenance. A possible way out of this dilemma is found in the fact that both these different types of laws agree in their aim to outlaw unfair methods of competition. But so-called "unfair-trade practices" have come to mean different things. In the former case, where ruthless monopoly is the public enemy, cooperation for price maintenance is collusion or conspiracy, whereas in the latter case, where ruinous competition is the great threat, price maintenance is upheld and price cutting is curbed. Sound social policy cannot be directed simultaneously toward opposite poles.

Anti-chain-store laws, which are directed especially against the use of loss leaders, may be viewed as efforts to prevent unfair competition by big business against little business. Price maintenance policy, be it good or bad, is more difficult to reconcile, because it is proscribed by some laws but protected by others. Price maintenance is permitted in some areas and not in others. It is a recognized program of marketing cooperatives, but a reprehensible policy when followed by industrial monopolies. It is gradually being accepted in such noncompetitive industries as public utilities.

It is difficult for government or business to ride simultaneously in opposite directions. It is possible, however, that monopoly may be desirable in a public utility but undesirable in another industry. Although it may be good public policy to permit price maintenance among cooperatives and small businessmen and to forbid it to large industrial corporations, such a dual program is difficult to defend and even harder to administer. In this case, our distinction ceases to be a choice between monopoly and competition, but a differentiation in size of unit, or character of industry; cooperatives are operated for mutual benefit instead of private profit.

23–20. Alternative Solutions. There are, as we have seen, four possible governmental policies toward monopolies, namely, (1) indifference, (2) dissolution, (3) ownership, and (4) regulation. An attitude of indifference or "hands off" the trusts cannot seriously be considered. Competition is regarded as a basic institution of capitalism. A policy of liberalism, which relies on private enterprise and opposes governmental interference with business, rests on the assumption that competition exists and works toward social welfare by increasing efficiency, decreasing prices, and improving quality. On more practical grounds, government cannot be indifferent to

the threat of monopoly or the "invisible empire of big business"; it cannot ignore the charges of unfair competition or exorbitant prices.

The opposite policy of dissolution of monopoly and restoration of competition by governmental action raises two familiar questions. Is dissolution possible? If possible, is dissolution desirable? Our previous discussion has indicated the difficulty of dissolution. It has also shown how "regulation by the axe" has given way to regulation in the light of reason and expediency.

A program of governmental ownership and operation has been defended as the proper policy for natural monopolies of organization, such as public utilities. The familiar arguments for and against governmental ownership will be given in the following chapter on public utilities. The socialists advocate public ownership and operation of all basic industries. Their case will be heard in a later chapter.

The remaining alternative, that of governmental regulation of the trusts, is a difficult policy, although it may well be the wisest and most expedient. It requires consistent definition of unfair practices by legislators and courts. It requires also industrious investigation and able administration by government bureaus. Finally, it requires wise differentiation without unjust discrimination among various types of monopolies.

Cooperatives and small merchants may be entitled to special consideration; they may be permitted a policy of price maintenance under certain circumstances and for some goods. Nor should competition be sought in such natural monopolies of organization as public utilities. As will be seen in the following chapter, they may be granted exclusive but short-term franchises and placed under the control of public-service commissions with power to fix prices and to supervise quality. The absence of competition requires such authority.

23–21. Federal Incorporation and License. In the case of large industries engaged in interstate commerce, Federal incorporation, as suggested in Chap. III, has been advocated. A Federal license for existing business corporations engaged in interstate commerce, as formerly required under the National Industrial Recovery Act, also seems desirable. Federal licensing of all big businesses engaged in interstate commerce, other than railroads, which are supervised by the Interstate Commerce Commission, and commercial and investment banks, supervised respectively by the Board of Governors of the Federal Reserve System and the Securities and Exchange Commission, would increase the ease and improve the quality of the work done by the Federal Trade Commission, which would continue to be the governmental agency charged with the supervision of big business and the suppression of unfair methods of competition in interstate commerce. Federal licensing of big business might accomplish the upward standardization of industrial reports and practices, as was sought under

the NRA codes. It might increase cooperation and raise planes of competition from predatory to productive practices.

23-22. Recognition of Monopoly and Regulation of Price. The present powers of the Federal Trade Commission are those of investigation, prosecution, and publicity. Its aims are merely the suppression of unfair practices and the preservation of competition. If the dissolution of a monopoly is difficult or undesirable, should it not be given frank recognition as such by the government? In such event, the Federal Trade Commission would have to be given the authority to approve price and to supervise quality of product, a power that it does not now possess. This is the "gun behind the door," or the weapon of last resort against monopoly.

Such action would give permanent authority to the Federal Trade Commission over a limited number of commodities, comparable to the temporary but more general power enjoyed by the Office of Price Administration during the Second World War. Such action, however, would be in line with that taken toward the railroads, electric light and power companies, and other natural monopolies of organization, which must have their rates approved and their services supervised by the Interstate Commerce Commission and State Public Service Commissions.

The Federal Trade Commission would enjoy such power over price and product only in those large or unusual industries in which competition had been tried and failed, and where its restoration seemed either economically impossible or socially undesirable. A thorough investigation and a public hearing would be required before an industry could be committed to such "strait-jacket" custody.

Guide Questions on Text

1. Why was state regulation of the trusts attempted? Why ineffective?
2. Outline leading provisions of the Sherman Anti-trust Act.
3. Show how it was modified by important judicial interpretations.
4. Was our policy of "trust busting" wise and successful? Why or why not? Wherein? To what extent?
5. Show how public attitude toward the trusts has changed. Cite court decisions. Suggest reasons.
6. Explain purpose, powers, and organization of the Federal Trade Commission.
7. How did the Clayton Act modify the Sherman Act and affect trusts?
8. What were the purpose and the effect of the Webb-Pomerene Act?
9. Give purpose and provisions of the Miller-Tydings Act and of state fair-trade laws.
10. Wherein has our governmental policy toward big business been consistent and inconsistent?
11. Show how the judicial concept of interstate commerce has changed.
12. Do you favor Federal incorporation of big business? Why or why not?
13. Argue the case for or against Federal licensing of big business.
14. Should the Federal Trade Commission be given the power to fix the prices of goods in interstate commerce? Why? How? Why not?

Topics for Investigation

1. Strength and weakness of the Sherman Anti-trust Act.
2. Dissolutions under the Sherman Act.
3. Success of the Clayton Act as antitrust legislation.
4. Purpose and provisions of the Robinson-Patman Act.
5. Experience of the Federal government in price fixing during the Second World War.
6. Effect on competition of codes under the National Industrial Recovery Act.
7. Big business under the "Square Deal" of Theodore Roosevelt and the New Deal of Franklin D. Roosevelt.
8. Anti-chain-store legislation.

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See also Selected References, Chap. XXII.

CHAPTER XXIV

LEGAL MONOPOLIES AND PUBLIC UTILITIES

24–1. Legal Monopolies. Legal monopolies are creatures of the law. They originate from a governmental grant to private parties or from an assumption of some economic function by the government itself. Patents, copyrights, and exclusive franchises are private legal monopolies. Governmental ownership and operation of essential and noncompetitive industries are public legal monopolies, which may be Federal, state, or local in scope.

a. Private Legal Monopolies. Although patents and copyrights are private legal monopolies, they are defended on the broad grounds of social expediency. They are regarded as desirable incentives to creative imagination and individual enterprise; they are considered essential safeguards to protect inventors against piracy of their original ideas by later imitators. Hence, these legal monopolies are viewed as aids to the economic progress of the entire group, as well as sources of private profits to their owners. The justification of patents and copyrights is that of a proper extension of property rights from commodities to ideas, not that of an improper expansion of special privilege.

The Constitution gives Congress power to "promote the progress of science and useful arts by securing, for limited times, to authors and inventors, exclusive rights to their respective writings and discoveries." [1] The granting of patents and copyrights, therefore, is an exclusive power of the Federal government. The Patent Office, originally a bureau of the Department of the Interior, is now located in the Department of Commerce.

b. Public Legal Monopolies. Public legal monopolies have been created for various reasons. The tobacco business in France and the salt industry of Saxony have been governmental monopolies because of their lucrative revenues. Moral considerations, however, have made the sale of distilled liquors a governmental monopoly. It was hoped that the elimination of private profits would remove the pecuniary incentive to promote increased consumption of strong drink.

The classic illustration of a public legal monopoly is the post office. The aims here seem to be increased efficiency of operation, a sense of nationalism engendered by governmental mails, and a desire to give remote sections of the country the same low rates and good services as those enjoyed by

[1] Art. I, Sec. 8, Par. 8.

more populous districts. Local public monopolies are illustrated by municipal waterworks, gas plants, and subways, governmental ownership of which has been defended because of the undesirability of competition in these industries and because of the essential nature of those services. Another consideration has been low rates to consumers, made possible by subsidies out of general taxes.

24–2. Natural Monopolies of Organization. Natural monopolies of organization, as previously shown, are those industries in which competition is self-destructive or undesirable, due to the physical impossibility of competition or to the financial pressure of indirect costs. It would be foolish, for example, to have competing gas, water, or sewage companies lay several sets of pipes and conduits under the same street. Such a procedure obviously would be both wasteful and inconvenient. The telephone and the telegraph industries likewise are natural monopolies of organization. Similar duplication of equipment and effort would result from competition in those utilities. Moreover, each businessman would be forced to subscribe to two or more telephone services in order to reach all other subscribers. Municipal streetcars, subways, and elevated railroads also are natural monopolies of organization for similar reasons.

The basic issue, therefore, is not one of natural monopoly versus futile competition, but rather one of public versus private monopoly in such industries. The real choice is between governmental ownership and operation or private ownership and operation under governmental regulation.

24–3. Overhead Charges and Industries of Indirect Costs. An industry of indirect costs, as we have seen, is one in which there has been a heavy investment of fixed capital, necessitating burdensome interest payments thereon, irrespective of the volume of business done. Other fixed charges are maintenance of equipment and payment of property taxes and insurance premiums. Operating charges, on the contrary, are those which arise from actual production; they vary roughly with the volume of business done. Costs of raw materials and wage payments illustrate operating expenses.

In an industry in which there are heavy fixed charges it is profitable to increase and to maintain the volume of business at the point of maximum capacity, in order to spread indirect or overhead charges over the greatest possible volume of production. In this way, costs per unit of product decrease. The significance of indirect costs became apparent in our previous discussion of dumping. They are vital to our present analysis of public utilities. Because competition is uneconomic in such industries, they are known as natural monopolies of organization. Examples are the electric light and power industry, gas and waterworks, railroads and streetcar lines.

24–4. Effects of Competition on Natural Monopolies of Organization. Public opinion has been slow to recognize the fact that most public utilities

are natural monopolies of organization. Competition formerly was invited, and in some cases insisted on, although its effects were bound to be wasteful. This situation was illustrated nationally by the railroads and locally by telephone and electric services.

Rate wars led to a cutting of charges as low as operating expenses; neglect of "overhead" was so great that some companies were "carried under." The weaker competitors succumbed, and their properties were eventually taken over by the stronger survivor. The single, resultant company was burdened with useless and duplicate equipment; it was bothered by lack of coordination in the construction of the formerly competitive lines. In order to cover swollen overhead charges, the new system was generally forced to raise its rates.

This experience of the railroads was similar to that of local public utilities such as telephone and streetcar lines, gas and electric plants. Competition was formerly regarded as the life of all trade, natural monopolies of organization not excepted. Public-spirited councilmen demonstrated their freedom from the political control of corporations by issuing franchises to competing public-service companies. Rate wars ensued that temporarily delighted the consuming public. Such a condition, however, did not long endure. Either one company failed and was absorbed by the other, or the competing companies came to an agreement to coordinate their services or to restrict their respective spheres of activity.

24–5. Characteristics of Public Utilities. Public utilities are such natural monopolies of organization, manufacturing necessary commodities or rendering essential services. Substitution by consumers is as impossible as competition by producers is undesirable. Everyone needs water, light, heat, and transportation. These basic commodities and services must be had at any price. Moreover, competition cannot be relied on to fix a just price, in the sense of a cost-of-production price.

Another feature of public utilities is the uniformity of their commodities or services. Competition is desirable where there is a wide range of choice open to the consumer. Appreciable difference of quality may be found, for example, in the pastries of various bakeshops and in the services of different barbers. Public-service companies, however, do not furnish a variety of goods but only a single uniform product, such as pure water, gas of a specified quality, continuous electric power, and transportation service of a particular type. Different tastes and differing pocketbooks are ignored; all consumers may buy at standard rates.

Utilities are public or quasi-public industries, not only for the foregoing reasons, but also because of their political origin and their legal power of eminent domain. Public-service companies generally enjoy the authority to condemn and the right to purchase private property for essential social use. On the other hand, they require a special legal grant, known as a

franchise, before operation, and special governmental regulation during their operation.

24–6. Social Significance of Public Utilities. Efficient and economical management of public utilities is closely related to community health, safety, and comfort. An impure water supply jeopardizes public health, and an insufficient water pressure increases the menace of fire. Hence, most American cities now have municipally owned and operated water systems to provide an adequate supply of pure water to all residents.

Similar problems of public health, safety, and general welfare are involved in other utilities. Thus, city planning is dependent on improved transportation facilities. Urban congestion has been relieved by high-speed transportation lines. The automobile has created the suburbs, but the exodus of higher income groups has left cities with blighted areas of outmoded houses, converted into multiple dwellings for lower income groups. Planned community improvement requires not only better housing, but also coordinated and efficient transportation. It also necessitates adequate water supply and sewage disposal.

Finally, electricity is now a necessity and not a luxury. This public utility has grown from numerous, small, local power plants into giant electric systems spreading over an entire state or several states. The growth pattern of electric-power companies has been similar to the earlier evolution of trunk railroads from small local lines and the more recent integration of local telephone companies into great systems.

24–7. Nature and Importance of Franchises. A charter of incorporation is a company's certificate of its legal right to exist, which every corporation must possess. A franchise, on the other hand, is a public-utility company's certificate of its right to do business of a quasi-public character involving the interests of all citizens. A franchise is a contract containing mutual considerations and conditions of agreement. A charter of incorporation can be secured from any state, but a franchise only from that state in which the utility plans to operate.

In most European nations, a franchise is merely a license or privilege revokable at the discretion of the franchise-granting body. Under our political system, however, there are constitutional provisions that prevent public authorities from revoking franchises except for specific violations of their terms. Thus, the Federal Constitution forbids a state to impair the obligation of contract or to deprive a person of life, liberty, or property without due process of law. This property guarantee has been used to preserve the sanctity of contract as well as the freedom of contract. It has been applied not only to individuals, but also to fiduciary persons such as corporations. Franchises once granted are contracts between the governmental unit and the corporation. Revocation or even alteration of the provisions of a franchise has been interpreted as an unconstitutional attempt to impair existing contracts.

24–8. Abuses of Franchises. American municipalities and states have given away valuable privileges belonging to the entire community. Franchises have been written for 99 years and even for 999 years. Conditions have changed, but succeeding generations have been bound by clauses in franchises originally granted by "responsible" bodies. The dead hand of the past has thus retained its hold on many growing communities, restricting their development.

Most states now have provisions in their constitutions that give their legislatures power to amend and to repeal all charters hereafter granted to private corporations. This power has been upheld by the courts with regard to public-service corporations, provided that such regulations are neither confiscatory nor unreasonable. Reduction of charges by public-service commissions cannot be so drastic that it results in the elimination of profit on a prudent investment. Moreover, when a franchise specifically states the right of a corporation to charge a certain rate, in return for which privilege that corporation pays a stated fee or agrees to perform certain services, such as repairing streets, a contractual relationship arises between the company and the public authority granting the franchise, to alter which has been difficult.

24–9. Overcapitalization or Stock Watering. *a. Capitalization of Monopoly Profits and Privileges.* Huge monopoly profits, concealed by overcapitalization, were formerly common among public utilities. Reorganizations were opportunities for watering the stock of merged or consolidated corporations. Holding companies were convenient devices to concentrate control and to pyramid profits. Stock was often issued on the basis of capitalized monopoly profits or exclusive franchise privileges in excess of the real capital assets of all the combined or subsidiary companies. Hence, modest rates of return on this watered stock were really huge returns on the real or original capital investment. Such overcapitalization concealed the high profits of those promoters who "watered" securities to the detriment of subsequent investors and exploited consumers.

Many such monopolies were not making excessive profits, if one accepted as their basis of computation the par value, or even the market value, of their securities, instead of their real book value. Their inflated capitalization was often far greater than the fairly appraised value of their physical assets or the fully computed value of their actual capital investment. Indeed, the preferred stock of some corporations still represents roughly the value of their tangible physical assets, and the common stock the "water" or capitalized monopoly profits. The market value of such common stock has sometimes been as great as that of the preferred stock, for it possessed abundant earning power even without corresponding tangible assets.

Great blocks of common stock often went to the promoters of such industrial monopolies or utility empires as rewards for their financial strat-

egy. This stock was subsequently bought or inherited by other individuals. Consequently, a later attempt at dissolution of the company or deflation of its stock worked an injustice to "innocent investors" who had received their stock after overcapitalization of the company had taken place.

b. Capitalization of Exclusive Franchises. Some public utilities were capitalized at two or three times the amount of their original investment or at several times the current value of their tangible assets. This accounting discrepancy was avoided by placing a high value on their valid franchises and patents, or sometimes merely on their fancied "good will." Many public utilities had secured exclusive and long-term franchises from state legislatures or municipal councils. They subsequently capitalized these free-gift franchises, and then justified their high charges as necessary to earn a "fair" rate of return on their inflated capitalization.

The Philadelphia Union Traction Company, organized in 1895 to unify the operation of the formerly independent street railways of that city, obligated itself by the terms of its lease to pay rentals equivalent to 5 per cent interest on the combined capitalization of the original companies, amounting to approximately 110 million dollars. The figure of 35 million dollars [1] was later found to be a fair value of the physical assets or the actual capital invested; the remaining 75 million dollars was the capitalized value of intangibles, consisting chiefly of free-gift franchises held by underlying companies.

The streetcar situation in Chicago [2] in the "trolley era" at the turn of the century was almost as bad, because 75 million dollars out of a total capitalization of 120 million dollars represented the value of the traction franchises, or the capitalized value of the Chicago street-railway monopoly. Again, in this case, the riding public were forced to pay in carfare a return on the capitalized value of the monopolistic franchises, which their legislators had previously given away to a small inside clique of vested interests.

24–10. Conditions in Franchises. The proper duration of a franchise varies with the industry and with the locality. A perpetual franchise is indefensible. Indeed, it is hard to justify one that extends for more than 25 or 30 years. Moreover, franchises should grant the community the option of taking over the industry at the expiration of the franchise period at a price based on a fair appraisal of its physical assets.

Massachusetts devised a plan by which franchises were granted for indefinite periods, but revokable at any time after a specified date. Investors, however, do not like to place funds in industries of uncertain life span. They seek more protection than that given them by such a franchise. The best interests of both consumers and investors are preserved by

[1] According to Professor Spiers in "The Street Railway System of Philadelphia."
[2] According to a report of the Civic Federation of Chicago, 1901.

definite but short-time franchises with periodic renewals on mutually satisfactory terms.

There is little objection to granting exclusive but temporary franchises if the industry is a natural monopoly. But such an exclusive franchise should not be capitalized, because the public should not be forced to pay a high return on a privilege freely given. Such an exclusive franchise should be revokable on violation of its terms or failure of the utility to maintain proper standards of service. It should be renegotiated at stated intervals.

24–11. Safeguarding Public Interests. The award of franchises to public-service companies presents two aspects, namely, the fiscal and the social. Cities can keep down their taxes on real estate by the imposition of charges for privileges enjoyed by public-service companies. On the other hand, it may be more desirable to provide the community with a cheap and satisfactory supply of some necessary commodity or service than to obtain increased revenue.

In the former case, the city would get funds from the sale of a franchise, which might then properly be capitalized by the utility to the amount of its purchase price. In the latter case, however, capitalization of the franchise freely given should not be permitted; citizens would be provided with transportation at lower rates because of the reduced capitalization on which such earnings are based.

In the past, both fiscal and social aspects have been ignored; neither advantage has accrued to the public, for franchises were formerly given away and subsequently capitalized. In order to safeguard community interests, public-service commissions have been created and laws passed to safeguard the issuance of franchises. Highway privileges have been granted to utility companies in return for money rentals or the performance of certain services for limited periods of time; generally they are neither sold nor given away.

24–12. Public-service Commissions. In addition to their scrutiny of franchises and finances of public utilities within their respective states, public-service commissions must approve the rates charged and supervise the services rendered. Consequently, it is important to determine and to enforce standards of performance. It is similarly necessary to fix a fair rate of return on, and an accurate value of, the capital investment represented. Public-service commissions, therefore, have been empowered to inspect the equipment and to appraise the properties of public utilities doing an intrastate business within their own borders.

A flexible policy of periodic rate determination by a public-service commission seems more desirable than one that prescribes in the franchise the exact charges to be made. Conditions change; prices, wages, and interest rates fluctuate. A reasonable charge at one time may be unfair or unprofitable some years later. Conditions also differ among communities and

utilities. A reasonable charge in one place or industry may be too high or too low in another.

24-13. Growth of Utilities. Utilities have not all developed at the same time, to the same degree, and at the same rate. During the era of railroad building, national canals and turnpikes were neglected. In later years, the development of our telephone systems exceeded that of our telegraph systems. At the present time, communication by radio is supplementing, if not supplanting, transmission by wire of message or voice. Although gas works have increased in number, value, and output during the past decade, their relative importance has decreased in comparison with the even greater development of electric light and power systems. Indeed, one of the outstanding features of the recent development of public utilities has been the expansion and integration of electric-power production and transmission companies.

24-14. Increasing Use of Electric Power. The recent rapid growth of the electric light and power industry can be seen from the fact that private investments in this utility in 1930 were valued at over 11 billion dollars, as compared with less than 1 billion dollars in 1903 and slightly over 1 billion dollars in 1908. Since the New Deal, public investments in power projects by various governmental agencies have been tremendous. Electric energy produced totaled 43 billion kilowatt-hours in 1920, 95 billion kilowatt-hours in 1930, and 145 billion kilowatt-hours in 1940. About one third of this total amount of electrical energy has been hydroelectricity, and two thirds have been produced from steam generators.

One of the most significant features of this growth of the electric light and power industry is that the cost of current to consumers decreased, in spite of a general increase in costs of living during most of this period. When the price of electricity is refined in terms of changes in the purchasing power of money, the decline in rates is intensified. It would seem that, in the long run, the electric light and power industry is one of decreasing costs. It has been praised as a progressive industry, whereas the railroads have been criticized as unprogressive utilities.

24-15. Development of Huge Electric-power Systems. Technological progress within the electric light and power industry created giant power and superpower. The small generating plant, serving a particular industry or local community, became obsolete as huge generating units and long-range transmission systems came into existence. The generation of hydroelectricity and its effective transmission required enormous capital investment, wide expansion of the corporate structure, and close integration of numerous small independent companies into large coordinated systems.

Many electric-power companies found it desirable to negotiate agreements with neighboring companies so that they could pool their reserves of excess plant capacity. In case the peak loads of the two companies came

at different times of the day or year, or in case of unforeseen emergencies, a mutually desirable hookup permitted the transmission of reserve electric power when and where it was most needed.

Such a general development was economically and socially desirable. A comparable problem had been solved a generation earlier by the unification of small local railroads into great trunk systems. The more recent growth of the electrical industry was accompanied by a similar concentration of control in an equally complex corporate structure. The holding company was a common and effective device for concentrating control and pyramiding profits.

24–16. Abuses within the Electric-power Industry. Many combinations of electric-power companies were not those of integration into natural systems. Some were dictated more by pecuniary strategy than by engineering economies. Instead of integrating the electric-power industry within a particular geographical region and staying out of other distant and noncontiguous areas, each holding company sought to buy a controlling interest in any utility, wherever situated, that offered hope of profit. In some cases it purchased control of related or competitive industries, such as gas or ice plants.

The result was a number of far-flung, but loosely held together, empires of public-utility holding companies that overlapped each other geographically and competed with each other for funds and favor. The financial structure was so complex and so interrelated that it suggested economic feudalism or imperialism. One company owned another company, which, in turn, controlled a third company, which had a special interest in still a fourth.

Some of these giant utility systems were financially sound, but others were grossly inflated; some operated within one geographical area, but others had interests scattered over the whole United States or even throughout the entire world. Corporate interests were so diffused and corporate structure was so complicated that honest officers were confused, while dishonest officials conspired to milk one corporation for the benefit of themselves or another corporation. Perhaps the greatest evil was the temptation to pyramid corporation upon corporation by the holding-company device in order to conceal or to concentrate the profits of subsidiaries.

The stock-market crash of 1929 burst the inflated balloon of security values, blown up with the hope of still greater profits. The pyramid of utility holding companies, resting upon other holding companies and subsidiary operating companies, suddenly crashed to the ground.

24–17. Federal Regulation of Utility Holding Companies. As Governor of New York and as President of the United States, Franklin D. Roosevelt was interested in public ownership and critical of private interests in the electric-power industry. His chief target was the expansion of public-

utility systems by the pyramiding of holding companies. Positive action was taken by the formation of the Tennessee Valley Authority, a regional experiment in governmental operation. A negative attitude was expressed in the Public Utility Holding Company Act of 1935, that contained the "death sentence." A neutral policy of regulation was evidenced by the expansion in 1935 and 1938 of the authority of the Federal Power Commission, to be discussed later.

Instead of prohibiting from interstate commerce all holding companies in the electric-power industry, as first suggested, it was finally agreed merely to limit their proliferation. This was sought by the Public Utility Holding Company Act of 1935. One holding company might own stock in another holding company, but the process of corporate inbreeding could not go further. One holding company might own the stock of several subsidiary companies, provided they operated within the same geographical area and within the same industry. Union of distant or different utilities was discouraged. Governmental registration of holding companies was mandatory.

Utility holding companies held that this legislation was an unconstitutional extension of the Federal power over interstate commerce. Moreover, the extensive use of the holding-company device was defended as a means of integrating the electric-power industry into great systems and of permitting the coordination and supervision of subsidiary companies. A wide geographical distribution of operating companies made for a diversification of interests that protected investors. Although gas and electricity were competitive fuels or illuminants, and although ice plants were rivals of electric refrigerators, there were some economic advantages in their coordination or combination. On these grounds, many large holding companies in the electric-power industry defended their existence and opposed their dissolution.

The unscrambling of these sprawling utility systems was supervised by the Securities and Exchange Commission, with final approval or disapproval of their reorganization by the courts. This process was long and involved; it was strenuously opposed by vested interests.

The Public Utility Holding Company Act of 1935 was called the "death sentence" of the electric-power industry by private investors. Although contested in the courts, this law was sustained in 1938 by an important decision of the United States Supreme Court, ordering the dissolution of the Electric Bond and Share Company.[1]

Some public-utility systems were dissolved and others were simplified. The general program was one of forced sale or voluntary exchange of the securities of subsidiary companies by the holding companies that owned

[1] *Electric Bond and Share Co. v. Securities and Exchange Commission*, 92 F. (2d) 580, P. U. R. (N. S.) 299 (1938).

them. Dissolution proceedings resulted in considerable depreciation or deflation of the market price of private investments in public utilities.

24–18. Federal Power Commission. This administrative body was created by the Federal Water Power Act of 1920 to improve inland navigation; it was also given jurisdiction over power projects on navigable rivers and public lands. The Federal Power Commission was reorganized in 1930. Its powers were greatly expanded by the Public Utility Act of 1935, which granted it authority over the interstate transmission of electricity and its sale to local utilities.

Under a recapture clause in this law, the Federal government, or any state or municipality designated by the Commission, has the right to take over any licensed hydroelectric project at the expiration of the licensed period upon payment to the licensed party of the net investment, not to exceed the fair value of the power project at the time of recapture.

The Natural Gas Act of 1938 conferred on the Federal Power Commission similar control over the interstate transmission of natural gas and its wholesale distribution to local utilities. But with natural gas there was no license power over projects, similar to that required for the generation of electricity, especially hydroelectricity; consequently, the act of 1938 had no recapture feature.

24–19. River-valley Reclamation by the Federal Government. *a. Aims.* The New Deal included a vast program of public works, among which was the development of important river basins. Combined, but sometimes conflicting, aims were (1) flood control, (2) irrigation, (3) transportation, and (4) power production. Instead of permitting a great river to wend its own way to sea, with alternating seasons of flood and drought, the construction of huge dams and reservoirs could store water, which would, in turn, make possible a steady stream for the irrigation of land and for the production of hydroelectric power.

b. Tennessee Valley Authority. The Tennessee Valley Authority, previously referred to in connection with the problem of soil conservation, consisted of a board of three men, authorized to develop the resources owned by the Federal government near Muscle Shoals, in Alabama. It was given the right of eminent domain, authority to employ large numbers of workers, and other extensive powers. Centralization of authority was designed to fix responsibility and to reduce political logrolling.

The purchase of the Muscle Shoals site in 1916 by the Federal government was prompted by its desire to secure a future supply of important minerals, such as nitrates and phosphates, for the manufacture of explosives and fertilizers. The project was subsequently widened to include water control and land reclamation. Finally, the program was expanded into one of economic and social planning for the entire region. The immediate concerns of the Tennessee Valley Authority, as previously shown, were the re-

duction of soil erosion in that general area, the regularization of water flow along the Tennessee River, and the production of cheap hydroelectric power.

An indirect result, it was claimed by its advocates, would be the determination of a yardstick of value, *i.e.*, a basis of comparison for the costs of producing electric current under private and public operation. Such a yardstick of value was bitterly criticized by privately owned utility companies also engaged in the production of electric current. They argued that costs were not comparable, because the Federal government furnished free to the Tennessee Valley Authority many services that the stockholders in privately owned and operated utility companies were forced to purchase. A market for this electric current had to be found in the surrounding territory, which formerly had been using more primitive sources of light and power. Such a demand could be stimulated only by selling electric current at a low price, lower than more realistic costs of production under private management. It was objected that taxpayers all over the United States, including competitive power companies, were forced to subsidize this development of the Tennessee Valley and this extension of public ownership.

c. Other River Projects and Proposals. Similar Federal constructions are the Grand Coulee Dam and the Bonneville Dam along the Columbia River in Oregon. Another is Hoover Dam along the Colorado River, which has been impounded to form Lake Mead in Nevada. The twin objectives of both projects are the generation of hydroelectricity and the regularization of water flow to permit irrigation and to prevent floods.

A current proposal is the expansion of the present Mississippi Flood Control into a proposed Mississippi Valley Authority, similar to, but greater than, the Tennessee Valley Authority. An additional or a substitute proposal has been that of the Missouri River Authority. This great area has suffered drought in the region of its tributaries, but floods at the mouth of the Missouri River.

The projected St. Lawrence Waterway envisions steamships from across the Atlantic Ocean sailing to and through the Great Lakes to docks in Buffalo, Cleveland, Detroit, and Chicago. There is the additional hope of generating hydroelectricity. This project is not merely interstate; it is international in scope. Like other river-valley projects, its cost would be enormous, and its aims seem to be in conflict with each other. Similarly, its construction is opposed by private interests, in this case not only by electric-power companies, but also by the railroads.

24–20. Encouragement Given Public Ownership of Utilities. The Public Works Administration expressed its willingness to lend funds for the public ownership of power projects, even where privately owned plants were already in existence. Duplication of equipment and loss of legitimate investment threatened until court decisions could be obtained. Meanwhile,

advocates of public ownership expounded upon the hope of lower electric rates thereby and the resulting increase in consumption of electricity.

Many consumers, attracted by the possibility of lower rates, failed to analyze elements in costs of electric current, to compare benefits of public and private ownership, and to visualize the fact that governmental subsidies to public utilities come out of the pockets of taxpayers. In short, what citizens gain as consumers, the same or other citizens pay in taxes, unless losses from public enterprises in one field are balanced by profits in another area of governmental operation.

While public ownership and operation of the electric light and power industry were being encouraged by the construction of a huge project for the generation of hydroelectricity by the Tennessee Valley Authority and the offer of loans by the Public Works Administration for public acquisition of existing plants, private ownership and operation were being discouraged by heavy taxation. Public-utility companies paid not only the income tax required of all corporations, but also additional special taxes. The depressing effect of the New Deal on private enterprise in this industry is illustrated by the fact that whereas in 1927 taxes took 9.4 cents of every dollar received in revenue by public-utility companies, in 1933 taxes took 12.7 cents, and in 1934, about 15 cents, representing approximately a one-third increase in six years and a one-half increase in eight years. This heavy taxation of privately owned and operated utility companies, in the face of governmental subsidies and loans to public projects, was criticized as unfair and discriminatory. Should it be continued, the dual burden of heavy taxation and keen competition will sooner or later prove prohibitive to many privately owned and operated utilities.

The immediate effect of this threat of public ownership and operation to the electric light and power industry was a sharp lowering of charges. A gradual reduction in electric rates, however, had already been in progress for many years. Even during the inflationary periods of the two world wars, costs of electric current did not go up with the increase in general costs of living. In some places the charge for electric current remained fairly stable; in other places it actually declined.

24–21. Development of Public Ownership. Some collective ownership and operation are necessary to carry out essential functions of government. Provision for national defense and public education, for example, must involve governments in business. Carrying mail and maintaining post roads are other old and familiar activities of governments. The scope of the postal system has been expanded to include the transportation of parcels and the establishment of savings banks. During the New Deal, the Federal government, as we have just seen, expanded its program of public works.

The growth of modern cities has increased the number of things that can better be done collectively than by private enterprise. Thus, the village

pump has given way to municipal waterworks, and private cesspools to a public sewage system. Other utilities, such as gas, electricity, and transportation service, came somewhat later. Although still left largely to private enterprise in this country, many European municipalities have gone into the business of supplying these essential commodities in an efficient manner at reasonable prices.

24–22. Phases of Public Ownership. Collective ownership has both its national and its local aspects. The government-owned railroads, telegraph, and radio systems of Europe illustrate the former, and municipal waterworks and subways are examples of the latter.

Many American states likewise have programs of public ownership and operation, such as state forest reservations and road projects. Indeed, it was with the states that the first great movement in public ownership began in this country. In the period before the Civil War, for illustration, numerous states engaged extensively in the construction of turnpikes and canals.

In recent years, public operation and ownership have been most conspicuous in our national life. The outstanding example, the Tennessee Valley Authority, has been evaluated.

During the First World War, America experienced governmental operation of the railroads, but not governmental ownership. It is significant, however, that this experiment was not repeated during the Second World War. But soon after victory a strike of engineers resulted in a temporary seizure of the railroads by the Federal government.

Federal operation of the coal mines during industrial disputes, however, was more extended during and after the Second World War. Coal strikes have occurred so frequently that the nationalization of our mines has been suggested as the long-run solution. But it is not certain that this drastic measure would promote industrial peace and prosperity.

24–23. Municipal Ownership and Private Operation. Some American cities have tried the compromise of public ownership with private operation of high-speed lines, such as subways and elevated railroads. The Philadelphia Gas Works, which originally had been municipally operated, were subsequently leased for private operation, under an exclusive franchise subject to periodic renewal. Such cases of public ownership and private operation are obviously the converse to private ownership with public operation, as illustrated by the railroads in the First World War and the coal mines in the Second World War.

24–24. Public Ownership in the United States and Europe. Municipal ownership has been limited in the United States. The most common illustration is our waterworks. Here the dominant motive has been neither efficiency nor economy in operation, but the assurance of a pure and adequate water supply. Still later, there was a similar development in some

seaport cities toward municipally owned wharves and piers; it was advocated as a method of increasing commerce and relieving congestion of shipping.

Public ownership has been more extensive and more satisfactory in Europe than in the United States. There, state ownership of railroads, telegraph, and telephone lines is the rule rather than the exception. The municipal aspect of governmental ownership and operation is especially significant. Many British cities can be cited as outstanding examples of efficiency and economy in municipal ownership and operation of public utilities and housing projects. The same is true of many continental cities.

Political changes in Europe between the First and Second World Wars gave public ownership, whether national or municipal, a tremendous impetus. All over the world, ideals of community service and greater cooperation within the group were rekindled. The revolution in Russia stimulated public ownership and operation, not merely of public utilities but of many other industries. New republics of Europe were favorably disposed toward programs of nationalization and municipalization or to governmental aid to cooperative enterprises of a voluntary sort. After the Second World War, the Labor government of Great Britain took over the Bank of England and nationalized its central banking system. Subsequently, it nationalized the coal mines and planned to do so for the steel industry.

24–25. Advantages and Disadvantages of Public Ownership. *a. Arguments Concerning Costs.* Most arguments concerning public ownership center about cost and service. Advocates of public ownership contend that the elimination of private profits would reduce the cost of the commodity or service to the consumer. Public utilities, like industrial trusts, formerly reaped huge monopoly profits. Public ownership would reduce the cost to the consumer by the elimination of private profits. Again, there would be further saving by the reduction of interest charges on capital invested. The rate of interest on government or municipal bonds is lower than that on the bonds of private corporations. These savings should be reflected in lower prices to the consumer.

b. Arguments Concerning Service. These assumptions concerning costs are closely related to the controversial contention that public ownership gives superior service. A private company, for example, would not ordinarily make extensions of tracks or mains unless it expected a reasonable profit in return. On the other hand, the community spirit and public pride might be enlisted in the interests of extending the service and increasing the efficiency of public enterprises. The municipalization of public utilities has given many European cities superior service, as well as lower rates.

American experience, however, has not been so favorable toward governmental ownership. It is alleged that public service in this country has

been inferior, both to that of civic service abroad and to that of private management at home. American consumers have received from some publicly owned plants a grade of water or gas service that they would not tolerate from a company organized for private profit. Our inefficiency in public operation results in waste and extravagance, which cause excessive operating expenses. This factor is more than sufficient to offset any financial savings due to lower interest charges. Critics of governmental ownership, therefore, conclude that consumers would pay higher rates or receive poorer service thereby than is now the case under private ownership and management.

c. Political Aspects. Public utilities have influenced municipal politics as the trusts have affected national politics. Governmental ownership would remove from our public life this sinister influence of the "state within the state," or "the invisible empire of big business." The corrupting force of private corporations seeking public franchises and political favors would be eliminated.

On the other hand, public ownership might create a far graver political problem than it would eliminate by the introduction or the increase of the "spoils system." The maintenance of the political independence of the Civil Service would be jeopardized by the governmental ownership and operation of public utilities. The professional politician gets his power from the public jobs that he can distribute to those who "vote right." The municipalization of public utilities would increase the number of political dependents of the ward boss. The nationalization of other utilities would magnify and disseminate this same problem of political patronage.

d. Labor Aspects. Public ownership would bring serious labor problems to our governmental authorities. Thus, an acute crisis was precipitated when the policemen of Boston went on a strike while Calvin Coolidge was Governor of Massachusetts. Would the workers in municipalized gas plants, waterworks, or streetcar lines be permitted to strike, or would such a movement by governmental employees be prohibited? If so, how would labor disputes be settled and how could governmental employees be compelled to remain at work against their will? In 1946 there was a short but serious strike of railroad engineers and trainmen, despite the fact that the national government took over the railroads during this national crisis. The coal miners also went on an even longer strike in the same year. After another crisis they returned to work for the national government of the United States, which, however, made important concessions to their demands. This situation stimulated popular demand for a revision of the National Labor Relations Act.

It is alleged that better working conditions prevail under public ownership than under private management. Both sides put forward the claim of higher wages. It would seem, however, that many public-service occupations, such as those of letter carriers and school teachers, have been notori-

ously underpaid. The salary schedules of some governmental employees express their comparative political importance, rather than relative civic needs or differences in qualifications.

e. Attractiveness of Public Service. It is claimed that an extension of public ownership would attract a better type of employee to governmental bureaus. But at the present time more great executives of America are found in business than government. The tone of political life is higher in Europe, where public service is able to draw more capable civil servants. Indeed, public service there is a professional career.

f. Elimination of Overcapitalization. Public ownership would eliminate the evil of overcapitalization through the issuance of stock against franchise privileges. On the other hand, it is contended that private management is so much more efficient and progressive than public operation that its resultant gains outweigh the burden of overcapitalization. Finally, the capitalization of free franchises, like the issuance of long-term franchises, is no longer done; this problem is of mere historical interest.

g. Undesirability of Competition. Defenders of public ownership point out the impossibility or undesirability of competition in public utilities and the essential nature of the commodity or service produced by them. From these two premises they reach the conclusion that only public ownership and operation of these natural monopolies will be able to secure that degree of social control necessary for the safeguarding of public interest.

Opponents of public ownership admit these two premises, but deny the conclusion that governmental ownership is the only alternative, or even a satisfactory solution. They argue the case for private ownership and operation under a system of public regulation. Some favor exclusive but temporary franchises with public recapture rights after a specified period. They believe that sufficient regulatory power over prices and quality of service would permit effective regulation of private companies by public-service commissions.

h. Arguments from Experience. Both sides appeal to the "argument from experience" to prove their views, and much good evidence can be gathered by each side, either in favor of or against public ownership. On the whole, it would seem that European experience has been more favorable toward public ownership than has our American record. But this weight of experience here and abroad cannot be measured and expressed in comparable or commensurate terms, for the two situations are very different. In any event, the trend toward governmental ownership has progressed further and faster in Europe than in the United States. The case for it is generally strongest with public utilities, which are natural monopolies producing essential services or necessary commodities.

24–26. Futility of Sweeping Generalizations. In conclusion, it may be observed that the problem of public ownership cannot be settled as a general proposition for all communities, for all utilities, and for all time. As

a purely local issue this perennial question may have no absolute or definite answer. If there is a strong community spirit, public ownership will probably succeed. If there is political apathy and a dearth of executive ability in public life, it will most likely fail. The same community may be successful with public ownership of one utility but not with another. Public ownership may be favored for the water supply of a city, but not for its transportation system. National ownership of the mines does not follow from national operation of the post office.

This problem cannot be settled now for future generations, for we live in a dynamic society. One should not be influenced by a desire to bring about governmental ownership in general or by a desire to eliminate it entirely or permanently. It is not a wonder-working panacea, nor is it a dread scourge which should be stamped out wherever and whenever it appears. Public ownership should be debated with particular emphasis on the individual features of every case. Important issues are often evaded by generalizations concerning "an obvious trend" toward public ownership or its "inherent weaknesses" and "inevitable failure"; these are prejudicial expressions.

As socialism involves the collective operation of basic agencies of production, it has been alleged that governmental ownership of public utilities is a step in that direction. Selfish interests have often used this "scarecrow" to drive off the timid friends of public ownership. To stigmatize a proposal with an unpopular name is much easier than to advance rational arguments against it. On the other hand, it is equally unfair to claim lower costs or better services for governmental projects, which are generously subsidized, in comparison, or in competition, with similar tax-paying industries conducted by private enterprise.

Guide Questions on Text

1. *a.* Distinguish between industrial and legal monopolies. Illustrate each.
   b. Show significance of distinction.
2. What are natural monopolies of organization? Why is competition therein unnatural and undesirable?
3. *a.* Differentiate between direct and indirect costs.
   b. Relate the problem of overhead charges to economic policy.
4. *a.* What are the essential characteristics of public utilities?
   b. Why are they important in such a definition?
5. *a.* What is a franchise?
   b. Distinguish it from a charter and a license.
6. *a.* What social considerations should govern the issuance of a franchise?
   b. What fundamental provisions should be embodied in them? Why?
7. *a.* Make out a case for or against the private ownership and operation of the sewage disposal system of your community.
   b. Do the same arguments apply to the waterworks? Why? Why not?
8. *a.* Make out a case for or against municipal ownership and operation of the gas works in your community.
   b. Do the same arguments apply to electricity? Why or why not?

9. Outline important provisions of the Public Utility Holding Company Act of 1935. Explain the "death sentence" therein.

10. Do you regard the compromise of public ownership and private operation as satisfactory? Why or why not? Illustrate.

11. *a.* What are some important functions of public-service commissions?
b. What qualifications can you suggest for the commissioners?

Topics for Investigation

1. Proposed changes in patent and copyright laws.
2. Municipal ownership of public utilities in Europe.
3. Capitalization of franchises to public utilities.
4. Greater efficiency in municipal services.
5. Progress of electric-power industry under private enterprise.
6. Electrification under the Tennessee Valley Authority.
7. Rural electrification in specific areas.
8. Amount and character of private investments in public utilities.
9. Discrimination in taxation of private utilities with subsidies to public projects.
10. Reorganization of public-utility empires under the Public Utility Holding Company Act of 1935.

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CHAPTER XXV

DEVELOPMENT AND REGULATION OF THE RAILROADS

25–1. Changing Methods of Transportation. Land travel was formerly on foot, on horseback, or by private carriage or public stagecoach. Travel on water was by the old-fashioned sailing vessel or the animal-drawn canal boat. During the early years of our national existence, popular desire to settle the West had stimulated the construction of turnpikes. This was followed or accompanied by the building of artificial waterways to supplement our natural system of rivers and lakes. The early part of the nineteenth century was the era of canals. The most conspicuous example was the Erie Canal, begun in 1817 and finished in 1825; it connected the Hudson River with the Great Lakes.

The Industrial Revolution changed means of transportation and communication, as well as methods of manufacture. The utilization of steam power facilitated travel, increased commerce, and opened new regions for development. The invention of the steam engine and its application to land and water transportation ended turnpike and canal construction. A generation of railroad building followed, and the "Iron Horse" finally made its way across the continent.

The later invention of the gasoline engine made possible the development of the automobile and the airplane. The supremacy of the railroad, in turn, was challenged by the popularity of motorbus, truck, and private automobile. The result was the recent revival of road improvement for motor vehicles with pneumatic tires.

25–2. Invention of Steam Locomotive. The earliest railroads were crude tracks for horsedrawn cars. An example is the Quincy tramway, built in 1826 and used to transport building stone for the Bunker Hill Monument. The rails used on most of these early projects consisted of wooden beams with straps of iron nailed to their upper surface.

The really distinctive feature of the railroad was the locomotive, for it substituted mechanical for animal power. The first successful locomotive dates from 1829, when the Englishman, Stephenson, ran his famous "Rockett" on its trial test on the Liverpool and Manchester Railroad at a speed of 29 miles an hour.

The pioneer railroad of this country was the Baltimore and Ohio, which ran westward from the new capital in Washington to the great plains on the

other side of the Allegheny Mountains. Like earlier canals and roads, it sought to connect the Potomac and Ohio Rivers.

25–3. Growth and Present Size of Railroads. In 1830 there were only 23 miles of railroad in the United States. During the next 10 years total railroad mileage reached almost three thousand, and by the time of the Civil War, about forty thousand miles. Most of the lines ran between eastern seaport towns. Railroad building made slow progress in the South, and the greater portion of the West was an uncharted wilderness.

After the Civil War, the building of American railroads proceeded at an unprecedented rate. In 1869 the first transcontinental road was completed, when the Union Pacific Railroad and the Central Pacific Railroad were joined in Utah. Other transcontinental lines to the northwest and southwest were then undertaken. The brief period from 1867 to 1873 witnessed the construction of 33 thousand miles of railroad. This was roughly equivalent to the total railroad mileage in existence a decade earlier.

Many of these roads were built in advance of the need for them. As their immediate earnings were not sufficient to pay interest charges on those enormous investments, many western railroad securities depreciated. This orgy of railroad building was largely responsible for the financial panic of 1873, precipitated by the failure of the Jay Cooke banking house of Philadelphia, which had underwritten a large issue of Northern Pacific Railway Company bonds.

After recovery from the depression of the seventies, the building of railroads again assumed enormous proportions. From 1880 to 1890 our railroad mileage increased from 93 thousand to 163 thousand miles. This net increase of 70 thousand miles in a single decade remains unequaled in the economic history of the world. It was accomplished not only by investment of private capital but also by generous governmental aid.

The peak of railroad mileage was reached about the time of the First World War, when the United States possessed 252 thousand miles of railroad, as compared with 218 thousand miles for all the nations of Europe combined, and as compared with 691 thousand miles for the entire world. Thus, with less than 6 per cent of the world's land area and with less than 6 per cent of the world's population, continental United States had 31.2 per cent of the world's railroad mileage.

Thereafter the development of motor transportation led to the abandonment of thousands of miles of unprofitable railroad lines. From 1920 to 1940, for example, railroad mileage in the United States decreased from 252 thousand to 234 thousand miles. Nevertheless, the United States continues to lead the world both in total railroad mileage and in trackage in actual use.

25–4. Public Aid in Railroad Construction. The railroads of the United States have been built and managed largely on private initiative. Although

several states constructed and operated a few miles of railroad in the early history of that industry, they soon disposed of them to private companies. The Federal government never engaged directly in railroad building, except for military purposes during the Civil War. It does, however, operate a line across the Isthmus of Panama, and it is undertaking the construction of a railway system in the Territory of Alaska. Nevertheless, Federal, state, and local governments of the United States gave substantial assistance in the early era of railroad building.

Some states aided the private construction of railroads from the very start. Others subsidized existing ventures or made possible their completion. Enthusiasm of legislators for canals and turnpikes was carried over into this new enterprise. State aid sometimes took the form of gifts, but more often that of loans to railroad companies. There was the same disregard for the fundamentals of sound finance that had characterized the previous era of state banking.

Local aids to the railroads also were important. According to the census of 1870, there were then outstanding 185 million dollars of county and municipal bonds that had been issued to aid railroad construction. Total investments of all governmental bodies in the stocks and bonds of various railway companies were estimated at 700 million dollars.

The national government began to assist railroad construction later than did the states, but it contributed even more generously. Although a few companies received large loans from the Federal treasury, most of the aid given by Congress consisted of grants of public land. At first, the land was given to the respective states as trustees, who, in turn, passed it over to the railroad companies; but later grants were direct. The most extensive land grants were those made for the construction of the transcontinental railroads. Thirty-three million acres, an area larger than the state of Pennsylvania, were offered to various corporations, later combined into the Union Pacific Railroad Company. The Northern Pacific Railway Company obtained land grants about equal to the state of New York. Total land grants to all railroads by the Federal government were almost equivalent in size to the state of Texas.

25–5. Railroad Systems of the United States. The railroads of the United States, like Topsy, have "just growed." Instead of coordination and cooperation, competition and duplication were common. Mismanagement and selfish manipulation often occurred; many railroads were financial failures. Out of their consequent reorganizations there gradually developed several unified systems, often as results of the individual enterprise of great captains of industry.

There are now several thousand railroad companies, few of which, however, operate their own lines. Most of them merely lease their trackage for operation by larger companies. Although there are still several thousand

independent operating companies, only those in Class A are important. These are roads having annual operating incomes of one million dollars or more.

In addition to the distinction between large and small railroads, and that between operating and underlying lines, railroads can be grouped geographically. A territorial classification used frequently by the Interstate Commerce Commission is into three districts—eastern, southern, and western. These districts are roughly divided by the Mississippi, Ohio, and Potomac Rivers.

A more complete geographical division of the railway systems of the United States follows. One group of railroads is that of New England, which includes the New York, New Haven, and Hartford Railroad and the Boston and Maine Railroad. Another district is that west of New England, east of the great terminals of Chicago and St. Louis, and north of the Ohio and Potomac Rivers. The railroads of this section have the heaviest traffic of any single division; they are, therefore, referred to as the "trunk" lines. Illustrations are the Pennsylvania, the New York Central, and the Baltimore and Ohio Railroads. Within this territory, there is a subdivision that is traversed by the so-called "anthracite" lines, such as the Philadelphia and Reading, the Lehigh Valley, and the Erie Railroads. The roads going south from Washington, such as the Atlantic Coast Line and the Southern Railroads, lead into the southern district, which is subdivided by the Allegheny Mountains into the southeastern and the southern sections. West of Chicago lie the wheat states, whose railroads are known as the "granger" lines; illustrations are the Burlington and the Rock Island. South and west of St. Louis lies another district, which is traversed by such roads as the Missouri Pacific Railroad and the Kansas, Texas, and Pacific Railroad. The transcontinental lines may be divided into two divisions; the northern section includes the Great Northern, the Northern Pacific, and the Chicago, Milwaukee, and St. Paul; the southern section includes the Union Pacific, the Atchison, Topeka, and Santa Fé, the Southern Pacific, and the Western Pacific.

In addition to this geographical grouping of railroads, there is a financial classification. Now merely of historical interest, it shows how certain great systems developed out of the maze of numerous small lines. Thus we have Gould, Vanderbilt, Morgan, Harriman, and Hill systems, named after the financiers who organized them.

25-6. Railroads as a Quasi-public Industry. Railroads, as indicated in the preceding chapter, are natural monopolies of organization. Because of heavy fixed charges on their huge capital investments, such industries operate under the principle of indirect costs. Additional business means decreased cost or increased profit per unit. The resultant struggle of the railroads for increased freight and passengers once took the forms of rate

wars, discriminations, and rebates. The futility of such competition, however, was shown by the formation of traffic pools and rate agreements. But the monopoly character of the railroads was slow in gaining recognition by public opinion, governmental legislation, and court decision. Finally, it was acknowledged, partially at least, in the Transportation Act of 1920. The full and frank recognition of the monopoly character of the railroads and of the completeness of Federal regulation thereof was incorporated into the Reed-Bulwinkle Bill, introduced into Congress in 1947; it proposed to exempt railroad rate agreements, approved by the Interstate Commerce Commission, from the application of antitrust laws.

The essential economic services, as well as the monopolistic nature, of railroads make them public utilities. Modern communities are highly specialized and mutually interdependent. Such a situation is conditioned by an efficient transportation system. Otherwise, tremendous economic waste and even loss of life itself would occur. If a complete strike of all transportation employees were to continue for any length of time, the economic life of our people would be paralyzed.

A railroad is a common carrier, which cannot refuse to carry any passenger or the freight of any potential shipper who complies with all reasonable conditions of transportation. In return, railroads, like other public utilities, possess the right of eminent domain. They may apply for the condemnation of private property for public use.

Finally, as just demonstrated, the railroads were developed by governmental aid. These investments of public funds and those grants of public lands must carry with them the concept of social interest and governmental regulation. Because of their quasi-public character, the railroads are subject to strict control by the Federal government, which now can prescribe not only the rates to be charged, but also the quality of service that must be maintained. In most foreign countries railroads must obtain their charters from the central government, but in the United States each state has the power to incorporate railroads just like other business enterprises. Nevertheless, Federal control has been secured by the power of Congress to regulate interstate commerce. At first, this power was sparingly used, but later it was extended into effective control.

25–7. Stages in Development. The first period was one of governmental subsidy without governmental control. As railroads were regarded as the carriers of prosperity, their growth was eagerly fostered. Although huge public aid was given, little public supervision was exercised over early railroad development.

The second stage, dating from 1870 to 1887, was a period of popular suspicion expressed in state legislation. Public opinion had discovered that the railroads could be agencies for evil as well as for good. Pooling and rate agreements were found to be common. Charges of extortionate rates,

discrimination, and monopoly were voiced. The result was a fever of investigation and regulation by state commissions. As most important railroads were interstate agencies, such attempts at state control merely indicated the necessity for Federal action, which was thereby initiated.

The passage of the Interstate Commerce Act of 1887 inaugurated the third general stage, that of national regulation, extending from 1887 to 1917, when the wartime expedient of Federal operation was tried. This period of national regulation may be subdivided by the Hepburn Act of 1906 into an early stage of feeble and negative regulation by the prohibition of unfair rates and practices and a later period of effective and positive regulation of rates and practices, provided by that law.

The fourth, brief stage, that of national operation, extended from President Wilson's wartime proclamation of Dec. 26, 1917, to the return of the railroads to private operation by the Transportation Act of 1920.

The Transportation Act of 1920 inaugurated the fifth stage, which was another period of national regulation. It frankly recognized the monopoly character of the railroads without accepting public ownership or operation. Effective regulation was sought through the Interstate Commerce Commission under a system of private ownership and operation. In its approval of railroad rates, governmental policy was more restrictive than generous.

The sixth stage was that of the great depression and subsequent years of attempted recovery. The railroads were in poor condition on their return to private ownership. They suffered from new forms of competition, such as motor and air transportation. A chronically bad situation in the prosperous twenties degenerated into an acute crisis in the thirties, when many important railroads went into bankruptcy, then into receivership, and finally into reorganization.

The seventh stage was that of the Second World War, when the former experiment of governmental operation was not repeated. Under private management the railroads of the United States did a magnificent job in moving an unprecedented volume of traffic with swiftness and safety. As the railroad is an industry of indirect costs, profits during this emergency increased even more markedly than the volume of business. This situation was the reverse of that in the preceding stage, when profits fell even more rapidly than traffic. Railroads with relatively heavy bonded indebtedness experienced the greatest leverage in either direction.

The eighth stage has been that of postwar adjustment. The prospects of the railroad, still are uncertain. Streamlined trains feature new comforts and faster schedules. Whether they can maintain a satisfactory volume of business, recapture traffic from motor vehicles, and compete successfully with even more recent and rapid transportation by air remains to be seen. Despite their reduction of overhead charges, increased wages and higher

costs of materials raised the operating expenses of railroads so that their postwar appeal for increased rates was granted.

25–8. Change of Popular Attitude toward the Railroads. The railroad was formerly regarded as a competitive industry, not as a natural monopoly of organization. Attempts to enforce competition produced confusion or new devices of concentrated control. Only after the monopolistic nature of the railroad was finally realized were these unfortunate efforts to engender or enforce competition abandoned. Meanwhile, the Interstate Commerce Commission gradually acquired effective powers of regulation over railroad rates, practices, and services.

Most of the early legislation concerning railroads was devoted to methods of aiding their development. During the seventies, however, the tide began to turn. The railroads, which formerly had been so zealously fostered, were then viewed with suspicion. The first indictment brought against them was that of excessive rates; it was gradually modified into the charge of discriminatory rates.

25–9. Rate Discriminations. Railroad discriminations were of three general types: discriminations as to commodities, discriminations as to localities, and discriminations as to shippers.

An alleged case of discrimination among commodities lay in the different freight rates on wheat and flour. Much wheat grown in the Northwest was, and still is, manufactured into flour in the great mills of Minneapolis and Duluth. At one time, however, the freight rate on wheat was lowered so much that it became profitable to ship wheat instead of flour directly to the Atlantic seaports. Hence, western millers contended that their business was being taken away from them by eastern millers because of this freight rate discrimination against flour. Freight rates thus influence the location of manufactures; they hold the power of life or death over many industries.

The determination of fair freight rates is as difficult as it is important. There must be some differentiation—not necessarily discrimination—between the rates charged for different commodities. The more valuable the commodity in proportion to its weight and bulk, the higher has been its freight rate. This common rate differentiation of the railroads between cheaper and dearer commodities has been termed "charging what the traffic will bear." Injured parties have indicted this practice as rate discrimination among commodities. Rate making will be treated in the following chapter.

Another type of railroad rate discrimination was that between different localities. Although the tariff on a particular type of freight ordinarily varied directly with the distance it was carried, this general principle did not always apply. Railroad rates were sometimes higher for a short haul than for a long haul, due to the existence of competition in the latter case.

Inland points, in particular, complained that they were discriminated against in paying higher rates for a shorter haul than those charged more distant seaports, which had competition by water transportation. The railroads replied that this situation was one of natural advantage or disadvantage of location rather than a case of artificial discrimination. Low rates to seaport towns merely secured additional business, which otherwise would have been lost to the railroads. In that event, still higher rates would have been charged on the traffic between inland points.

Discrimination among parties was the worst form of railroad rate discrimination. For the most part, it consisted of preferential rates to large shippers at the expense of smaller ones. Such railroad discriminations played a vital part in the formation of trusts. Most of these agreements were secret understandings, which were difficult to prove until publicity of rates was required. While there was outward adherence to a professed schedule of rates, discriminations took the form of secret rebates to favored shippers.

25-10. State Regulation. The change in public attitude from favor to fear of the railroads first appeared in the agricultural section of the Middle West, where it found its earliest expression in state legislation. Western statesmen vaguely indicted the railroads, these newly grown monsters, as the cause of many of the farmers' troubles. Instead of facilitating the movement of agricultural crops, the railroads were accused of limiting markets by prohibitive rates. Accordingly, various western states passed the "granger legislation" of the early seventies. These laws usually forbade discriminations in railroad rates; they sometimes sought to prevent excessive charges by fixing maximum freight rates for certain crops.

The railroads contested this legislation in the courts. Their soundest legal argument was that based on the limited authority of states over transportation. The chief arteries of national commerce were interstate. not intrastate. The Constitution had vested this power in the Federal Congress. If the regulation of interstate commerce was a power of the Federal government, it was its corresponding duty to exercise that power in the public behalf. Consequently, the Interstate Commerce Act of 1887 was then passed. The era of state regulation was thus terminated and that of national regulation began.

25-11. Interstate Commerce Act. The Interstate Commerce Act of 1887 applied to interstate and foreign freight and passenger traffic carried by the railroads, or, in cases of continuous shipment, by railroad and water. It did not apply to intrastate traffic, nor to interstate or foreign traffic carried entirely by water. It is significant as the first important piece of Federal legislation for the regulation of common carriers.

The Interstate Commerce Act may be divided into two parts: one prohibited discriminations and monopoly practices; the other provided for the establishment of the Interstate Commerce Commission.

a. Provisions and Prohibitions. The Interstate Commerce Act provided that all charges should be just and reasonable. It declared unlawful every unjust and unreasonable charge. Although not defining just and reasonable rates, the law did forbid certain bad practices of the past. For example, it prohibited personal discriminations in the form of special rates or rebates. It also forbade discriminations between localities, commodities, and connecting lines. It required reasonable and equal facilities for the interchange of traffic. Its famous "short and long haul" clause made it unlawful for a common carrier to charge more for a shorter than for a longer distance over the same line and under similar circumstances.

The act prohibited competing railroads from pooling their traffic or profits. A carrier might not interrupt unnecessarily the continuous passage of freight for the purpose of changing an interstate shipment into two or more intrastate shipments. Such practices had been resorted to in order to take advantage of more favorable intrastate rates.

The Interstate Commerce Act included fines for violations of its provisions. It also made a carrier liable for damages for losses sustained by a violation of the law. It provided that parties claiming to be damaged by unjust discriminations or other unlawful practices of a railroad could bring action for recovery.

All rates and fares should be printed and posted for public inspection. Schedules of rates and charges were to be filed with the Interstate Commerce Commission, the new body provided for in the second part of the act.

b. Establishment of Interstate Commerce Commission. This body was to consist of five members appointed by the President of the United States with the consent of the Senate. The commissioners might not engage in any other business while in office, nor might they own railroad securities. The term of office was to be six years, and not more than three commissioners might be members of the same political party.

The Interstate Commerce Commission was given power to inquire into the management of all common carriers. It might compel them to produce their records and give testimony. No witness might refuse to testify, although such testimony might not be used against him in criminal proceedings. Inquiries might be instituted on outside complaint or on the initiative of the Commission.

Each interstate carrier was to furnish an annual report covering its capitalization, equipment, receipts, and expenses. It should provide a complete and correct picture of its financial situation and operation in the form of a balance sheet and a profit and loss statement.

When an investigation was deemed necessary, the Commission was authorized to report in writing its findings and its recommendations as to reparations. If it appeared that the law had been violated, notice should be served on the offending railroad to desist from its illegal acts. When a common carrier refused to obey an order or a requirement of the Commission, it was the duty of the Commission to bring proceedings against it in a circuit court of the United States. The findings of the Commission as to facts were to be regarded in court as prima facie evidence.

c. Interpretation and Evaluation. The Interstate Commerce Act looked backward in regarding the railroad as a competitive industry, instead of taking a forward step in recognizing the railroad as a natural monopoly of organization. It sought to revive fair competition and to eliminate such unfair practices as rate discrimination. But the law was an improvement in that it subjected railroad practices to the scrutiny of the national government, for which purpose it provided a new Federal administrative body.

The Interstate Commerce Commission was given power to proscribe unfair rates, but not to prescribe fair railroad rates. It could merely declare an existing rate to be unreasonable. The Commission's powers were those of investigation, prosecution, and publicity. Its decisions were not binding on the railroads; they could be enforced only by ligitation in the courts.

The Supreme Court held that the powers of the Interstate Commerce Commission were only those specified in the act. As with prosecution of the trusts by the Federal Trade Commission, Federal courts failed to sustain the Interstate Commerce Commission in many of its early railroad suits. Jurists rendered decisions based more on their own than on the Commission's interpretation of the facts in the case. They allowed the defendants to introduce new evidence that had not been passed on by the Commission. The Federal courts also were reluctant to compel witnesses to give testimony of an incriminating nature.

On the other hand, the Interstate Commerce Act secured publicity of railroad rates. It eliminated some flagrant discriminations. Although the powers of the Interstate Commerce Commission were limited, a beginning had been made, and a permanent Federal organization had been created for the regulation of the railroads. As the course of subsequent railroad legislation is traced, it will be seen how the powers of this body were gradually increased from vague, negative prohibitions to specific, positive prescriptions.

d. Subsequent Modifications. The Sherman Act of 1890, discussed previously in Chap. XXIII, was applied to the railroads, although it was aimed more directly at industrial monopolies or trusts. In an effort to enforce competition, rate agreement among railroads was forbidden.

The Interstate Commerce Act of 1887 was amended by subsequent, supplementary legislation, including the Elkins, the Hepburn, the Mann-

Elkins, and the Panama Canal Acts, of which the Hepburn Act of 1906 was the most important. It was amended also by the Transportation Act of 1920.

25–12. Elkins Act. The Elkins Act of 1903 dealt almost exclusively with the problem of discriminations. It was designed to prevent the fostering of trusts by preferential treatment on the part of the railroads. The specific aim of this law was the elimination of secret rebates.

25–13. Hepburn Act. The Hepburn Act of 1906 marked the beginning of effective regulation of railroad rates by the Federal government. This law also extended the scope of the Interstate Commerce Act to express companies, sleeping-car companies, and pipe lines for the transportation of petroleum.

a. Prohibitions and Provisions. The Hepburn Act provided that no road should transport over its lines commodities that that company had mined or manufactured. This provision sought to end the discriminations practiced by coal-carrying railroads, some of which were interested in the mining and marketing of coal.

Publicity of rates was ensured by prohibiting common carriers from engaging in transportation without first filing their schedule of rates with the Interstate Commerce Commission. No deviations could be made except after thirty days' notice to the public and to the Commission. Free transportation of passengers and free passes, except in a few specified cases, were forbidden.

A shipper receiving a rebate from a common carrier should forfeit to the Federal government a sum equal to three times the amount of rebates received during the previous six years. The offering, soliciting, accepting, or granting of rebates was made a misdemeanor. Anyone convicted of such misdemeanor should be liable to imprisonment as well as a fine.

b. Increased Membership and Powers of the Interstate Commerce Commission. Membership was increased from five to seven, of whom not more than four members might be of the same political party. The term of office was slightly lengthened and the salary was substantially increased. The powers and duties of the Commission also were enlarged, as it gained in permanence and prestige. Whereas formerly it might only declare an existing rate unreasonable, the Commission might now determine reasonable rates, regulations, and practices. It might prescribe maximum railroad rates, as well as proscribe existing rates as exorbitant.

Orders of the Interstate Commerce Commission were to take effect within a reasonable time, unless invalidated by the courts. As a fine was provided for failure to comply with these orders, railroads could no longer ignore them. The burden of initiating litigation to test the validity of its orders was shifted from the Commission to the railroads. Whereas its directives had formerly meant little until supported by court order, they now became mandatory unless set aside by court decision.

Another advance was granting the Interstate Commerce Commission power to prescribe a uniform system of accounting for all railroads engaged in interstate commerce. Special agents and examiners were employed to inspect accounts of common carriers. In addition to the perfunctory annual reports for stockholders, the Commission began to make monthly surveys and to require more detailed information. It became an offense for railroad officials to mutilate, falsify, or destroy their records. Finally, efforts were made to give greater publicity to railroad rates and practices.

Although the Hepburn Act did not limit or specify the grounds on which Federal courts could annul orders of the Commission, in practice they have confined their activities to a consideration of the law, leaving unquestioned the factual findings of the Commission, which was thus recognized as a competent and authoritative administrative agency of the Federal government. Orders of the Commission were not to be set aside by the courts, unless it had exceeded its statutory powers or violated constitutional guarantees. The Supreme Court ceased to review and interpret the facts of each case. It continued to pass on the legality of the orders of the Commission, but not on their wisdom or expediency. The Commission and not the Court approved railroad rates and supervised their practices. This improvement in the status of the Interstate Commerce Commission was similar to, but even greater than, that enjoyed by the Federal Trade Commission in its regulation of the trusts.

25–14. Mann-Elkins Act. The Mann-Elkins Act of 1910 gave to the Interstate Commerce Commission power to suspend changes in rates announced by railroads until its approval had been secured. A carrier must file in advance a schedule of proposed rates, whereupon the Commission should make an investigation of the reasonableness of such an increase. Pending that study, the new schedule would be inoperative.

25–15. Panama Canal Act. The Panama Canal Act of 1912 made it unlawful, after July 1, 1914, for any railroad company to have an interest in common carriers by water operating through the Panama Canal, *or elsewhere*, with which the railroad may compete for traffic. The purpose of this law was to prevent the railroads from weakening the competition of coastwise steamship lines or those operating through the Great Lakes, as they had formerly destroyed water transport by barges through the canals.

25–16. Final Supremacy of Federal Control. Division of authority between interstate and intrastate commerce, simple enough in theory, was difficult of practical application. Although interstate and intrastate commerce followed the same transportation routes, often passing over the same railroads, two different authorities governed these matters. Such a situation led to much injustice and more confusion, as differences in interstate and intrastate rates formerly existed between equidistant points and even between the same towns.

This conflict between interstate and intrastate authorities finally culminated in the Shreveport Rate Case of 1914.[1] The Court decided that the lower intrastate rates were prejudicial to interstate commerce. It ruled that this distinction be removed by observing on both classes of traffic the interstate rates set by the Interstate Commerce Commission.

The final step in Federal control was taken in the Transportation Act of 1920, to be discussed in the concluding section of this chapter. This law states specifically that where an intrastate rate discriminates against interstate commerce, the Interstate Commerce Commission shall prescribe a rate that will be binding on both classes of traffic. In other words, Federal control over railroad rates is supreme, but not exclusive.

25–17. Federal Operation of the Railroads. *a. Authorization.* The Army Appropriation Act of 1916 authorized the President in time of war to assume control of the transportation systems of the United States. Acting under this authority from Congress, President Wilson, on Dec. 26, 1917, announced Federal control of the railroads; he named Secretary of the Treasury, William G. McAdoo, as Director General of the Railroads.

On March 21, 1918, the Railroad Control Act was passed to deal with problems arising from the President's wartime proclamation concerning the railroads. This law guaranteed to each railroad corporation an annual payment not exceeding its average, net, operating income for the three years ending June 30, 1917. The government was to provide for the maintenance and repair of equipment. A revolving fund of 400 million dollars was created to pay the expenses of Federal control. The President was authorized to initiate all charges, classifications, regulations, and practices by filing them with the Interstate Commerce Commission. The roads were to be returned to their owners within one year and nine months after the ratification of the treaty of peace.

b. Administration. The Federal Railroad Administration made many important changes. Joint use of terminals, cars, equipment, repair shops, and other facilities of individual roads was provided. Central control of routing and distributing traffic relieved somewhat the severe congestion. Duplicate service was eliminated and economy effected by the use of standardized equipment.

A central administrative bureau was established in Washington, and the country was divided into operating districts, each in charge of an experienced railroad official. Railroad presidents disappeared and Federal managers took their places. The identity of individual lines was temporarily lost, and the coordination of all transportation facilities was eagerly sought. Express companies also were required to consolidate into a single company, control over which was likewise assumed by the Federal government.

[1] *Houston Railway Co. v. United States* (the Shreveport Case), 233 U.S. 342 (1914).

The Federal Railroad Administration organized regional and district rate committees, which took the place of the former traffic associations. As increased revenue was necessary, freight rates were advanced 25 per cent and passenger fares were raised to 3 cents a mile in May, 1918. Unfortunately, this financial relief did not come until a serious deficit threatened. Meager railroad earnings during these years were in marked contrast to high war profits in other industries.

The principle of collective bargaining was recognized and a nonpartisan Railway Wage Commission was appointed. The eight-hour day was adopted; wages were standardized and substantially increased.

c. Evaluation of Governmental Operation. The general arguments for and against governmental ownership and operation of public utilities were outlined in the preceding chapter. The student is asked to review them and to make his own application to the railroad industry. He is reminded that there was governmental operation, but not governmental ownership, of the railroads during the First World War. Moreover, the experiment was undertaken only for a brief emergency; the period cannot be regarded as typical. The success or failure of what was primarily a war measure offers little proof on either side of the argument concerning the advantages and disadvantages of public ownership.

Instead of our own appraisal, we shall paraphrase the conclusion of an outstanding authority [1] on transportation, as follows. From the standpoint of operating results, the management of the railroads by the government was on the whole satisfactory, although arbitrary measures were necessary to obtain the movement of essential traffic. From a financial standpoint, however, the results of Federal control were not so satisfactory. In any event, this experiment was not repeated during the Second World War, which was longer and greater than the First World War.

25–18. Transportation Act of 1920. The Transportation Act of 1920 contained provisions for (1) the return of the railroads to their owners for private operation on Mar. 1, 1920, (2) a method of fixing railroad earnings, (3) the consolidation of the railroads, (4) an increase in the membership and powers of the Interstate Commerce Commission, and (5) new machinery for the settlement of labor disputes.

a. Financial Conditions of Return to Private Operation. Important financial provisions were included for the transfer of the railroads to private operation. For the following six months, the law guaranteed them a net return equal to the rentals paid during governmental operation, but with the option of immediate financial independence after Mar. 1, 1920. If a railroad elected to continue its guaranteed rentals, any excess in its earnings was to be returned to the Federal government.

[1] Johnson, E. R., and T. . Van Metre, "Principles of Railroad Transportation," p. 510, D. Appleton-Century Company, Inc., New York, 1926.

An appropriation of 300 million dollars was held as a fund from which the railroads might secure loans during the next two years. The equipment of many roads had so depreciated that their demands for new rolling stock and other capital outlays were imperative. Those railroads which were indebted to the government because of expenditures for equipment were permitted to fund their obligations for a period of 10 years with interest at 6 per cent.

Fares and rates in existence at the end of Federal control were not to be reduced during the guaranteed 6-month period except with the approval of the Interstate Commerce Commission. Furthermore, it was stipulated that no reductions in wages or salaries were to be made within the same period. The financial position of the railroads at the end of the war was deplorable. Many authorities held that these provisions were neither sufficiently elastic for effective operation nor generous enough for adequate compensation.

b. Fixing Railroad Rates and Earnings. The Commission was authorized to divide the country into rate districts and to prescribe a rate for each district, which, under efficient management, would yield a net income sufficient to pay a "fair" rate of return upon the capital invested. The Commission should make a valuation of the railroads from time to time to determine the amount of their investments. A "fair" rate of return was fixed at 5½ per cent for the two years following Mar. 1, 1920. It was provided, however, that an additional one-half of 1 per cent might be allowed for capital investments in the form of additions or betterments.

All railroads, even those within the same rate district, were not on an equal financial basis. But rates were required to be uniform, despite the fact that the stipulated return might be more than sufficient for a strong railroad, but not enough for a weak road. The government, therefore, introduced into the Transportation Act of 1920 the principle of profit sharing, which, however, was subsequently repudiated. All profits in excess of the statutory rate of 6 per cent were to be divided into two equal parts. One half of the excess profits might be kept in reserve by the road earning them, but the other half was to be turned over to the Commission as a general railroad contingent fund. This collective fund was to be used for making loans to weaker railroads and for acquiring railroad property by the Commission to be leased to operating companies. As the recapture feature of the law was abandoned, this profit-sharing plan was inoperative, and the contingent reserve for loans to weaker railroads was not available in the depression years.

c. Possibility of Railroad Consolidation. The Interstate Commerce Commission was directed to prepare a plan for the consolidation of the railroad properties of continental United States into a limited number of systems. Nevertheless, the pious hope was expressed that competition should be

preserved as fully as possible. It was evident, however, that the only competition among railroads was in services rendered and not in rates charged.

The Transportation Act of 1920 provided that the several railroad systems be so arranged that the cost of transportation, as between competitive systems, and as related to the value of railway property, should be the same. It was assumed falsely that if all systems would apply uniform rates on competitive traffic, they would earn substantially the same rate of return.

Some consolidation has taken place since 1920, but not as much as had been anticipated, nor as much as might well be done. Consequently, agitation has continued in favor of further combination of individual railroads into integrated systems, and of small systems into still larger and even better integrated systems.

d. Membership and Powers of Interstate Commerce Commission. The Transportation Act of 1920 increased the membership of the Interstate Commerce Commission to eleven and the salary of each member to $12,000. It strengthened still further the powers of the Commission, which was given authority to name minimum, as well as maximum, rates. The problem of the railroads had shifted from excessive to inadequate rates.

The Transportation Act of 1920 sought to preserve the gains of cooperation that the First World War had engendered and that a future conflict might similarly require. The Interstate Commerce Commission was given power in case of such national emergency to exercise control over the car service of the railroads. The Commission's consent was made necessary before a railroad could undertake the construction of extension or branch lines. The railroad development of the future, if not of the past, was to be planned as a whole and in advance. Moreover, the Commission was given authority to require the joint use of railroad terminals and other facilities, where it seemed necessary, and under terms prescribed by the Commission. Finally, the law permitted the pooling of traffic earnings. The monopoly character of the railroad was finally written into law.

25–19. Bulwinkle-Reed Bill of 1947. This bill was designed to permit railroads to agree on rates, subject to approval by the Interstate Commerce Commission. It would exempt railroads from antitrust legislation and not regard their rate agreements as criminal conspiracies in restraint of trade, subject to prosecution under the Sherman Act. Such legislation would formally and finally proclaim the railroads to be in law what they are in fact, namely, natural monopolies, in which cooperation is to be substituted for competition. Such a step appears to be in the right direction. The requirement of final approval of such rate agreements by the Interstate Commerce Commission would seem to be a sufficient safeguard of the public welfare against monopoly power in the hands of private interests. To date (1948) this bill or one of similar intent and comparable provisions has not yet been enacted.

Guide Questions on Text

1. Show the rapid growth and present importance of the railroads.
2. Classify geographically various important railroads of the country.
3. Why is the railroad regarded as a quasi-public industry?
4. *a.* Show the significance of railroad discriminations.
   b. Illustrate different types of discrimination.
5. Outline stages in the development of the railroad problem.
6. Give chief provisions of the Interstate Commerce Act.
7. Why was the Hepburn Act important?
8. What was the chief effect of the Panama Canal Act on the railroads?
9. Distinguish briefly between the Elkins and the Mann-Elkins Acts.
10. Outline carefully the important and permanent provisions of the Transportation Act of 1920.

Topics for Investigation

1. Era of turnpikes and canals in American history.
2. Invention of the steamboat.
3. Early railroads in the United States.
4. Transcontinental railroads and the settlement of the West.
5. Public aid in railroad construction.
6. State regulation of the railroads.
7. Judicial interpretation of the Interstate Commerce Act.
8. Interstate and intrastate railroad rates.
9. Railroads in the First and Second World Wars.
10. Plan to free railroads from antitrust regulations.

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See also Selected References in Chaps. XXIV and XXVI.

CHAPTER XXVI

MODERN ASPECTS OF TRANSPORTATION AND COMMUNICATION

26–1. Principles and Parties Concerned. The preceding chapter has demonstrated that the railroads, like other public utilities, are natural monopolies of organization. In the absence of competition to lower prices and improve services, effective governmental regulation is necessary to protect consumers against exorbitant rates and extortionate practices. The Interstate Commerce Commission, therefore, has gradually developed its regulatory powers over the railroads and other common carriers. So have the public-service commissions of the various states over their own intrastate utilities. What have been their guiding principles in the determination of a fair rate for transportation, communication, and other such services?

The concept of a fair or reasonable rate implies not only that the public must be granted protection against discriminatory and excessive rates, but also that the investor must be given some security in his quasi-public investment. Finally, labor also is involved. The effect of utility rates on wages and, conversely, the effect of wages on utility rates are important. The consumer should enjoy reasonable rates, the investor should receive a fair rate of return on his capital investment, and workers should be paid living wages. These are the three parties vitally concerned with the problem of utility rates, whose interests are sometimes in harmony but often in conflict. Let us now interpret these vague expressions.

26–2. Issues Involved. Although the expression "fair rate" is so vague that exact definition is difficult, its most common interpretation is one that yields an adequate rate of return on the capital invested. This so-called "cost-of-production" concept was expressed in the Transportation Act of 1920, discussed in the preceding chapter. Such an explanation does not constitute a workable definition; it merely reduces the issue to the following basic questions.

In the first place, what percentage should be regarded as a "fair rate" of return? In the second place, what value should be placed on the capital investment that is to be used as the basis for such a computation? In the third place, what schedule of charges will yield the accepted rate of return on the approved value of the capital investment?

26–3. What Is a Fair Rate? The Transportation Act of 1920 fixed the rather arbitrary rate of $5\frac{1}{2}$ per cent (with an additional one-half of 1 per cent allowance for additions and betterments) as a fair rate of return. Some students claimed that this rate was too low, and a few that it was too high. Perhaps the main issue involved is whether there can be a fixed rate of return for all years and for all utilities, or even for all railroads.

To differentiate between strong and weak companies by giving the latter a higher rate than the former would place a premium on inefficiency. On the other hand, charges may well be higher where volume of business is lower and where difficulties or risks are greater. To vary the rate of return with phases of the business cycle might seem equally reasonable but also impractical. To vary it with changes in the economic interest rate, as has sometimes been suggested, would be as difficult as the manipulation of the compensated gold dollar. Nevertheless, changes in the rate of interest must be reflected in, or related to, the approved rate of profit.

26–4. Railroad Valuation. Assuming a given percentage as constituting a fair rate of return, on what investment value should it be based? This question involves utility valuation, including both its theoretical principles and their practical application.

a. Tangibles and Intangibles. It is not clear what constitutes the fairest method of appraising the value of a railroad or any other public utility. Should its value be limited merely to that of its physical assets, or should it include such intangible assets as right of way or franchise privileges? Although a fairly good case, supported by numerous court decisions, can be made for the inclusion of certain intangibles, the danger of overcapitalization is peculiarly serious in public utilities, whose inflated values might be made the basis of rate determination. Chapter XXIV recounted how some streetcar companies had capitalized the value of franchises, which had been given to them for little or nothing, and subsequently used such overcapitalization as justification for high fares.

b. Original Costs or Reproduction Costs. Even if investment value is limited strictly to that of the tangible, physical assets of a public utility, this problem still is not solved. On what basis shall such value be established? A fairly good case can be made out for either of the two following methods of valuation: (1) original costs minus depreciation plus additions and betterments, or (2) current costs of reproduction less accrued depreciation.

A review of various court decisions shows that the basis of valuation has changed, and even that different methods of valuation have been suggested at the same time. But divergent methods of valuation cannot be used simultaneously with any greater success than that which attended the versatile horseman of Stephen Leacock, who mounted his charger and rode off in all directions. Our previous discussions of bimetallism demon-

strated that two commodities could not be used as standard money simultaneously without the difficulty of a deviation between the mint ratio and the market ratio of the two precious metals. An equally great confusion arises when two or more different methods of valuation of capital investment are attempted.

The Interstate Commerce Commission has been considering the basis of railroad valuation for the past generation. As soon as it acquired power to prescribe railroad rates, it was faced with the necessity of railroad valuation. By act of Congress passed March, 1913, the Interstate Commerce Commission was specifically directed to make a valuation of our railroad systems. The first method was to evaluate the physical assets of the railroads at their original costs plus additions and betterments and minus depreciation.

This valuation had not been completed when the Transportation Act of 1920 was passed. For the purpose of rate making at that time, the Interstate Commerce Commission placed a value of 18 billion dollars on the railroads, although the companies then estimated their capital investment in road and equipment at 20 billion dollars. Their corresponding figure for 1915 had been 17 billion dollars; for 1925, it was 23 billion dollars; from 1930 to 1932 it was 26 billion dollars; thereafter their valuation eased off to 25.5 billion dollars before the outbreak of the Second World War.

Original costs as the approved method of railroad valuation was challenged by a court decision in the case of the O'Fallon Railroad. The Supreme Court went on record to the effect that reproduction costs, as well as original costs, must be considered for rate-making purposes. However, it did not state that reproduction costs were to supersede original costs as the basis of rate making.[1]

In the 1920's the railroads had argued strenuously for reproduction costs instead of original costs as the fairest basis of valuation. Because the general price level was higher after the First World War than it had been before that conflict, reproduction costs would have given a higher value to railroad investments than original costs. Hence, the railroads' case for increased rates would have been strengthened. But hardly had the O'Fallon decision of 1929 introduced the doctrine of reproduction costs than the great depression brought falling prices and weakened the interest of railroad management in this particular method of evaluation for rate-making purposes. Rising prices after the Second World War, however, may again revive railroads' interest in reproduction costs as their basis of valuation.

26–5. Factors in Allocation of Railroad Charges. Assuming that a particular rate of return is fair, and, furthermore, that a given investment-value basis is correct, how can railroad rates be fixed so that they will yield

[1] *St. Louis and O'Fallon Railroad v. United States of America and the Interstate Commerce Commission,* 279 U.S. 461 (1929).

this fair rate of return on that correct appraisement? Even with these two factors definitely fixed, it is still difficult to determine in a given case just what is a proper railroad rate. This difficulty in fixing railroad rates is due to the fact that the railroad industry is not only one of indirect costs but also one of joint costs.

a. Indirect Costs. As an abstract proposition, it seems just that a railroad rate should be proportionate to the cost of rendering a particular service. The practical application of this principle, however, is extremely difficult. Railroad costs include both operating expenses and fixed charges on capital investment. Operating costs vary directly with the volume of business, but they are fairly constant per unit of traffic. On the other hand, overhead costs are nearly the same, irrespective of the amount of business; increased volume of traffic, therefore, results in lower per unit overhead charges.

It would seem obvious that the charge for transportation should be proportionate to the weight or bulk of the freight and to the distance that it is to be carried. The very nature of the railroad industry, however, is such that costs of transportation do not increase proportionately with either of these two factors. The cost is less per ton to transport trainloads than carloads, and less per ton for carloads than for still smaller loads. Likewise, expenses per mile grow less as the distance increases because terminal expenses and other fixed costs of train movements can be spread more widely over a long haul than over a short one.

b. Joint Costs. The railroad is an industry of joint costs, as well as one of indirect costs. Joint costs are those expenses which are involved in the simultaneous production of two or more commodities or services. Refining crude petroleum into gasoline, the main product, and kerosene, paraffin, and other by-products is the classic illustration of joint costs. A similar situation exists in the railroad industry.

Capital invested in railroad tracks, bridges, and tunnels is devoted to the transportation of both freight and passengers. The cargo of a single freight train, in turn, consists of many different products. To divide the common costs of producing place utilities between persons and things or among different commodities is a difficult matter. To decide which is the main product and which is the by-product transported is not easy.

The fact that the railroads operate under the principle of joint costs, as well as that of indirect costs, renders difficult the application of the cost-of-production theory to the determination of fair railroad rates.

26-6. Value of Service Rendered. A different theory of railroad rate determination substitutes value of service rendered for cost of production. This method seeks to fix railroad rates according to the values added to articles by their transportation from one place to another. All other things being equal, if a bushel of grain is worth 10 cents more in an eastern city

than in the Dakotas, that increase in value can be attributed, in large part, to the place utility that the railroad creates by transporting it from a location of relative abundance and little value to one of relative scarcity and greater value. Services rendered, rather than costs incurred, are stressed as the basis of rate determination by this method.

Value of service rendered, however, is hard to determine for freight, and still more difficult to measure for passenger transportation. But a rough approximation of it has been the chief basis of railroad charges. "Charging what the traffic will bear," as it has often been called, has been a guiding policy in rate making and one that has been sanctioned by the Interstate Commerce Commission. Only if this practice should be carried to its limit, and if railroads should attempt to appropriate the entire value of the service rendered, would their rates be regarded as unreasonable. Such a policy would ignore completely the element of costs in rate making.

Determining factors in this method of railroad rate making have been the relative values of the commodities themselves. Increases in values of cheap bulky articles, which can be attributed to transportation, are discounted; those losses are made up by higher charges on more expensive articles. Although such a policy savors of discrimination among goods, it is probably socially beneficial; it may, therefore, be viewed as progressive price differentiation in rates, which operates like a luxury tax, and which helps to distribute the burden of transportation charges among consumers where they can best be borne. Although "charging what the traffic will bear" or varying rates with values of different commodities has been a common railroad policy, no general attempt has been made to absorb all increases in place utilities on all articles transported. Costs of production cannot be ignored as a basis of rate fixing.

26–7. Upper and Lower Limits. In the practical determination of railroad rates there are upper and lower limits. Rates charged for any service must at least equal the costs incurred in performing that service, or, stated negatively, they must cover those expenses which would have been avoided had that service not been rendered. This lower limit has sometimes been described as "out-of-pocket" costs. On the other hand, no railroad charge can be greater than the value of the transportation service to the shipper or traveler, which naturally represents the upper limit beyond which rates cannot go without loss of business. To determine between those upper and lower limits what constitutes a reasonable and fair charge is the difficult task of governmental regulation.

26–8. Restrictive Attitude toward Railroad Rates. With the background of a generation of struggle against excessive and discriminatory rates, the coveted power of rate fixing was at first used negatively by the Interstate Commerce Commission for the prevention or limitation of increases in railroad rates. In spite of a serious decline in railroad earnings

during the first decade of the present century, and in the face of an increase in the general price level, which was attended by increased costs of railroad operation, the Interstate Commerce Commission construed its public function as one of protecting consumers by refusing, or reducing, or delaying the increases in railroad rates requested by companies.

When the Federal government took over the operation of the railroads during the First World War, it guaranteed profits on the basis of those earned during the preceding years. Because of the rise in the general price level and increased labor costs, net earnings of railroads fell below this guaranteed amount. Finally, in 1918, rates both for passengers and for freight were sharply advanced; this granted temporary relief to the railroads.

The first postwar business depression of 1921 brought decreased earnings. Railroads, which had previously experienced freight congestion and a shortage of rolling stock, then faced the problem of idle cars, due to lack of traffic. The Interstate Commerce Commission, therefore, again granted an increase in passenger and freight rates. Meantime, the Transportation Act of 1920 had put into effect its statutory rule for rate fixing.

26–9. Changes in Travel Habits. Between the two world wars a revolution took place in the travel habits of the American people. The automobile, first a luxury and then a necessity, came into increased popularity both for business and for pleasure. Consequently, railroad passenger travel and, to a smaller extent, railroad freight traffic suffered an eclipse until the outbreak of the Second World War, when the railroads again enjoyed a revival of business.

From a high mark of 47 billion miles in 1920, railroad passenger traffic declined to a low level of 16 billion miles in 1933; *i.e.*, it fell to one-third its former volume. Consequently, railroad passenger revenue similarly decreased from a high point of 1,305 million dollars in 1920 to a low level of 330 million dollars in 1933, or to one-fourth its former value. The net profits of railroads, as we shall soon see, declined even more sharply than their gross revenues. This drop was due partly to the transition from a period of prosperity to one of depression, but it was due also to a notable change in travel habits.

In 1920, the average travel for each inhabitant of the United States was only 500 miles a year, most of which was by rail. In 1933, however, our travel average had risen to 1,700 miles, or over three times its former amount. But of this higher travel average only 130 miles were by rail. In other words, average railroad travel mileage had fallen to less than a third its former level at the same time that our average for all types of travel had more than tripled.

In 1920, railroads handled 47 billion passenger-miles of traffic, as compared with 7 billion of intercity travel by private automobiles. By 1933,

however, our habits had so changed that total railroad passenger-miles had decreased to 16 billion or to about one-third its former level, whereas automobile travel had increased to a total of 185 billion passenger-miles or over twenty-five times its former level. This rapid change in the travel habits of the American people had important social and economic effects. At the same time that it reduced the revenues of the railroads, it increased the public expenditure of funds for road construction. Automobile travel developed suburbs, but it engendered a flight from the city by higher income groups, who, as indicated before, left behind them outmoded houses and blighted areas.

The conclusion of former Transportation Coordinator Eastman,[1] from whose report these figures have been taken, was that the decline in railway travel between 1920 and 1933 was due even more to the growing use of private automobiles than to the increased popularity of public motorbusses. Although busses had taken considerable passenger traffic from steam railroads, they had diverted even more business from interurban electric railroads. The plight of the railroads was deplorable, but that of the trolleys was desperate. Although built later than steam railroads, surface electric lines became obsolete even more rapidly. Many were replaced by busses; their rails were often abandoned or removed in road improvement. In some towns and cities, trackless trolleys, which could not be blocked, and subways, which cut under the traffic, replaced surface trolleys and elevated lines, which impeded traffic and increased its hazards.

26–10. Inadequacy and Irregularity of Railroad Earnings. Although sometimes large in absolute amount, railroad earnings, at least between the First and Second World Wars, were not excessive in relation to their huge investment of capital. During the prosperous twenties the average rate of return on the property investment of Class I railroads rose from little over zero in 1920 to 3 per cent in 1921 and then to 5 per cent in 1926; it fluctuated under 5 per cent until 1929, and thereafter declined rapidly and steadily to a low level of a little over 1 per cent in 1932. Even before the crash of 1929, some important railroads ran at a loss for several years. Their losses and the modest returns of other lines pulled the higher returns of stronger roads down to these low averages.

Decline in railroad traffic during the great depression of the early thirties and the minor recession from 1937 to 1938 reduced modest earnings to inadequate returns on the stronger roads and turned slim profits into great losses for the weaker roads. Formerly prosperous railroads were scarcely able to meet their heavy fixed charges, and some roads were forced into bankruptcy. To avoid further receiverships, great loans were made by the Reconstruction Finance Corporation to many railroads during this emergency.

[1] *The New York Times*, Sunday, Aug. 11, 1935.

The Second World War improved the financial situation of our railroads. Both passenger and freight traffic increased enormously. During the war, railroad profits rose even more rapidly than their traffic increased, just as their profits had decreased more sharply than their business during the preceding years of depression, due to their high fixed costs.

Railroad income increased markedly from 1938, a year of deficit and depression, to 1942, when they reached an unprecedented level, even higher than that of 1929. Rising costs and higher wages then cut into railroad earnings, which declined from 1942 to 1946, when a substantial increase in rates was finally granted.

Table 16 shows wide fluctuations in the annual total income of our railroads. The first column gives the net operating income of railroads before payment of interest on their outstanding obligations. The second column

TABLE 16. INCOME OF AMERICAN RAILROADS *

(In millions of dollars)

Year	Net operating income	Net income after interest payments	Year	Net operating income	Net income after interest payments
1925	$1,137	$ 771	1936	$ 676	$222
1926	1,229	883	1937	598	146
1927	1,078	742	1938	377	−87
1928	1,182	855	1939	596	141
1929	1,263	977	1940	691	243
1930	874	578	1941	1,010	558
1931	528	169	1942	1,499	993
1932	325	−122	1943	1,371	946
1933	477	27	1944	1,113	733
1934	466	23	1945	859	502
1935	505	52			

* U. S. Interstate Commerce Commission Reports.

shows net income after payment of interest to creditors. It can easily be seen how the heavy burden of bonded indebtedness drained the operating income of the railroads. In lean years, their modest operating income was insufficient to meet interest charges and a net loss resulted. In good years, the dual leverage of bonded indebtedness at low interest rates plus the factor of indirect costs rapidly raised net profits.

26–11. Emergency Railroad Transportation Act. The New Deal included provisions for the railroads, some designed to help their investors, but others to aid their workers. The general aim was a curtailment of rail-

road receiverships without reduction of railroad employment, a difficult task in the face of declining earnings and a dubious policy in view of decreasing traffic.

The Emergency Railroad Transportation Act of 1933 created a Federal Coordinator of Transportation, appointed by the President and approved by the Senate. The duties of the Coordinator were to substitute order for anarchy in transportation and to assist in the formulation of mutually satisfactory agreements among the railroads for the coordination of supplementary systems of transportation. Little consolidation, but some cooperation, resulted; competition was reduced and regulated. The orders of the Coordinator had the same legal status as those of the Interstate Commerce Commission, whom he supplemented but did not supplant during the emergency of the depression. The expenses of his office were met by assessments against the railroads, not by public taxation, as with the Interstate Commerce Commission. His directives were similarly subject to review by the courts.

The Emergency Railroad Transportation Act of 1933 repealed the "recapture" clause in the Transportation Act of 1920, which had temporarily injected the principle of governmental profit sharing into the railroad situation. This provision had meant very little, for few railroads had enjoyed excess profits as defined by the law. Their determination was difficult because of disagreement on methods of railroad valuation. The few railroads that had paid the Federal government its share of the alleged excess profits did so under protest. As these railroads were ultimately sustained by the courts, the "recapture" clause had already become inoperative.

26–12. Railroad Reorganizations. The most pressing financial problems of the railroads were a simplification of their financial structure and a reduction of their heavy interest charges. During previous periods of prosperity few railroads had removed or even reduced their bonded indebtedness. The decline in the general price level operated unfavorably against the railroads, because most of them were debtor organizations. It decreased the reproduction value of railroad investment, while it increased the burden of interest payment upon it. The decline in railroad earnings forced the reduction or omission of many dividends and even the default of interest on some bonds.

If the railroads were to be operated at a profit by their private owners or to be bought at a reasonable price by the Federal government, it was apparent that the capitalization of many roads had to be written down to a realistic figure. The securities of some had to be "put through the wringer" to squeeze out the water in their common stocks, for these equities were junior to the claims of bondholders and other creditors.

Reorganization plans were drawn up for railroads in bankruptcy under the supervision of the Interstate Commerce Commission and the Secu-

rities and Exchange Commission. They were then submitted to the creditors and courts for approval. One of the chief and prior creditors was the Federal government through loans granted by the Reconstruction Finance Corporation.

The general program was one of reduction in capital structure by the substitution of less for more bonds and the relegation of senior claims to junior securities. The old common stock was eliminated or drastically reduced. The general pattern was that of a first mortgage bond at a low but fixed rate of interest and a secondary income bond at a higher rate of interest, if earned, followed by preferred and common stock. In general, the corporate structure was simplified in character at the same time that the capitalization was reduced in amount.

The financial reorganization of some railroads, like the dissolution of certain utility holding companies, required many years. Meanwhile the Second World War had stimulated railroad traffic, reversed their operating situation, and raised their revenues. Increased industrial production had expanded the volume of railroad traffic, which, in turn, had converted losses into profits for the weak roads and swollen the profits of strong roads to figures that had not been anticipated a decade earlier.

26–13. Elasticity of Demand for Transportation. Before the Second World War sharply increased the volume of traffic and imposed severe restrictions on travel, efforts were made by some railroads to discover the elasticity of demand for their transportation services, *i.e.*, to find out how sensitive was the volume of railroad traffic to changes in rates. Some of these experiments were surprisingly successful, for lower charges occasionally brought such an increase in traffic that profits were greater at reduced rates than they had been formerly at higher rates. Cuts in passenger rates, when travel was light, stimulated trips to resort points. Special commuters' rates and shoppers' tickets induced residents of suburbs accessible to railroad stations to use trains to the city instead of driving their own cars or taking busses. The demand for transportation, like that for electricity, appeared to be more elastic than had been supposed. To state the problem differently, special rates to encourage fuller utilization of facilities during slack periods and to stabilize volume of business was found to be advantageous from both operational and financial standpoints.

26–14. Proposal to Postalize Railroad Rates. The success of some railroads in increasing gross revenues, and sometimes even net profits, by a reduction in rates or by the introduction of special rates led to the suggestion of "postalizing" railroad tariffs, *i.e.*, charging a flat sum for a particular type of passenger service or a certain weight of freight, irrespective of the distance it was transported. Although flat rates are generally accepted in ordinary mail delivery of letters, the United States parcel post operates on a zone system. Postalizing railroad rates has received some consideration, but very little support.

26–15. Improvement in Railroad Services. Many railroads have greatly improved their services. Coaches have been made more attractive in many ways; the comfort of passengers has been increased by air-conditioning and improved seating and lighting. Some roads have been electrified; others have introduced Diesel engines or improved steam locomotives. Many railroads have featured new streamlined models, most of which have decreased markedly the running time between important cities.

Even before their financial recovery during the Second World War, the railroads showed signs of revival and renovation, as well as a need for reorganization. With the decline in traffic after the successful conclusion of hostilities the railroads faced both the necessity and the opportunity of making still further improvements in their facilities, services, and schedules. New and even essential equipment was difficult to obtain during the war years. During this great crisis the railroads were forced to utilize outmoded cars and obsolete locomotives.

26–16. Railroad Transportation in the Second World War. The previous experiment in governmental operation of the railroads was not repeated. The Second World War, nevertheless, was longer in duration and greater in scope than the First World War had been. Indeed, freight and passenger traffic as a whole or on a monthly basis was several times as great. Ton-mile-day movement of materials increased to an unprecedented degree under able private management with the cooperation of railroad employees.

The successful operation of our railroads during the Second World War was facilitated by the creation of the Office of Defense Transportation, which replaced the previous office of Coordinator. The same general functions were retained, but the powers of this office were expanded to cope with the newer and still greater national emergency in railroad transportation.

26–17. Motor Transportation. Busses and trucks travel over public highways built and maintained at the expense of taxpayers. Railroads complain that they are forced to construct and to maintain roadbeds at their own expense. They pay huge taxes on their extensive rights of way and expensive terminals, in addition to their heavy maintenance costs. In reply, it should be remembered that the railroads received generous governmental help in their construction. It should also be noted that most states now have levied special taxes on motor vehicles, graduated according to their size and type. Such taxes help to construct and to maintain the public highways used in motor transportation, as do the taxes on gasoline paid by all motorists.

Motor transportation is more recent than that by railroads. Hence its social control has not been so fully and so effectively achieved. Moreover, much motor transportation is local and intrastate in scope. Finally, a large portion of it is by private automobiles and delivery trucks, which are not

common carriers. Most existing regulation of motor traffic and transportation, therefore, is by state and local agencies.

The Federal government did not undertake the regulation of interstate commerce by motor vehicles until after the passage of the Federal Motor Carrier Act of 1935. This law made the Interstate Commerce Act, as amended by subsequent legislation, applicable to interstate motor transportation by common carriers, contract carriers, and other commercial enterprises. It declared the national policy to be one of protecting for the general public the advantages of motor transportation against unreasonable charges and undesirable practices, such as discrimination and undue preference. As with the railroads, supervisory authority over interstate commerce by motor transportation was vested in the Interstate Commerce Commission.

26–18. Pipe-line Transportation. *a. Petroleum.* Just as electricity is conducted by wires and trains are run over tracks, so petroleum is often pumped and gas is always conveyed through pipe lines. Even before the construction of the "little inch" and the "big inch" pipe lines during the Second World War, there were over 115,000 miles of pipe line in the United States, built to move petroleum from oil wells to transshipment points or refinery centers. Some of these lines are the private property of certain oil companies, but others are common carriers engaged in interstate commerce and subject therefore to the jurisdiction of the Interstate Commerce Commission. It will be remembered from the preceding chapter that the Hepburn Act, amending the Interstate Commerce Act, placed pipe lines conveying petroleum, but not gas, under its control.

b. Natural Gas. There are now about 200,000 miles of natural gas lines, which convey this important fuel from its chief sources near petroleum deposits to great cities and industrial centers, where it is consumed in homes and factories. The expansion in natural gas consumption and the extension of natural gas lines have been significant recent developments.

There is a close relationship between the transportation of natural gas and its production, for the expansion of natural gas in the wells forces it up and into the pipe lines. In contrast, petroleum requires gravity or pumps to move it. Whereas petroleum can easily be stored in tanks, natural gas requires compression chambers for that purpose.

Natural gas companies are generally classified as public utilities and thus have the right of eminent domain. They are not, however, subject to direct Federal regulation. The Interstate Commerce Act specifically exempts from its provisions the transportation of natural gas and water by pipe lines.

26–19. American Merchant Marine. American shipping has been sheltered by laws that require our coastwise commerce to be carried in American vessels. This protection, however, does not exist in foreign trade, where competition from abroad has been keen.

To meet the urgent needs of the First World War, the United States government commandeered all available ships. It also built many new vessels. The Merchant Marine Act of 1920 authorized the United States Shipping Board to establish governmental lines or agents for the utilization of those vessels.

The revival of foreign shipping, the business depression of 1921, and notable improvements in ship construction made difficult the continued and successful operation of many of these emergency vessels. The United States Shipping Board, therefore, sought to dispose of its unprofitable lines and excess ships even to the extent of selling some vessels as scrap metal.

Another Merchant Marine Act of 1936 created the Maritime Commission, consisting of five members, to which were transferred from the Department of Commerce the functions formerly exercised by the United States Shipping Board. The chief purpose of this later act was to substitute direct, differential subsidies for American ship construction and operation for the former method of indirect aid by mail subsidies to American ocean liners. The direct, differential subsidy was supposed to represent the difference between American and foreign costs of construction and operation. It sought to keep American shipyards at work and American ships afloat.

Consequently, the Second World War found this country better provided with ships and shipyards than had been the case during the First World War. Nevertheless, the construction of still more ships was urgently needed in the global war that ranged over the Pacific Ocean as well as the Atlantic Ocean. Rapid construction was obtained by the prefabrication of ship parts and the substitution of electric welding for the former process of riveting.

Control over shipping during the Second World War was transferred from the United States Maritime Commission to the United States War Shipping Administration by executive order, in 1942. As the problems of war differed from those of peace, a new organization with different functions and greater powers was deemed essential for more effective cooperation with the naval officers.

The successful conclusion of the Second World War presented problems similar to those at the end of the First World War. In the interests of our foreign commitments and commerce, as well as those of national security, should not the United States maintain an ample merchant marine and an adequate navy? To do so, however, will require enormous subsidies and taxes. Higher prices and higher wages in the United States make it difficult for this nation to compete with foreign countries in the construction and operation of merchant ships. Postwar industrial disputes in the maritime industries have reduced popular enthusiasm for further subsidization of an American merchant marine. If foreign nations can perform these carrying services more economically than this country, they should, indeed, be per-

mitted to do so. In such fashion, they can secure American dollars to buy our goods and to pay their debts to us.

26–20. Air Transportation. *a. Development.* Navigation by water, as indicated in the preceding chapter, is one of the oldest and slowest methods of transportation; that by air is the latest and fastest form. Successful air flights by balloons were first made in the latter part of the eighteenth century, although dreams of flying must have haunted primitive man. The advent of the gasoline motor provided more reliable power than changing winds; it permitted the construction of heavier than air craft that did not require unwieldy gas bags. The latest development in aircraft is the speedy jet-propelled plane.

Although aircraft were used extensively and effectively in the First World War, mass transportation by gliders and long-distance flights by large ships were inaugurated in the Second World War. Indeed, aviation made unprecedented progress amid the ravages of these great conflicts, to which, in turn, it contributed so much devastation. The present order, civil and military, is so air-minded that a description of various types of aircraft is as unnecessary as it would be extraneous in a text on economic problems.

b. Increased Passenger Traffic. The growth in the volume of air-passenger traffic in the thirties was as revolutionary in transportation as had been the increase in motor transportation in the twenties, previously described. The number of passengers carried by air increased from 5,782 in 1926 to 1,176,858 in 1938. The number of passenger-air-miles increased from 84 million in 1930, the first year for which this information was recorded, to 476 million in 1937. In 1938, there were 17 companies engaged in domestic passenger-air-service and 7 companies engaged in the transportation of passengers by air to foreign countries and to our territorial possessions.

The exigencies of the Second World War diverted aviation from peaceful to military uses. Nevertheless, with only 166 planes, the commercial air lines flew 1,481,876,329 passenger-air-miles in 1942 as against 1,491,734,671 (approximately the same number) passenger-air-miles in 1941, when they had 359 airplanes (over twice the previous number). Available planes, like available railroad cars, were being used more continuously and more effectively. In 1944, with 279 airplanes the domestic lines carried 4,688,330 passengers, as against 461,743 passengers carried in 417 planes in 1934. In these ten years commercial airplanes had increased in size, although they had decreased in number. But the most significant thing is that passenger-air-miles had increased tenfold without marked increase in capacity, the latter on account of war diversion of the aircraft industry. Another tenfold increase in the postwar decade seems a conservative estimate. It would mean approximately 44 million air voyagers in 1955, about half of whom would use the facilities of New York, if the present ratios continue.

c. Present Significance of Air Power. The Second World War clearly indicated that few military operations can be carried out successfully without control over the air, although that in itself is not sufficient. It is now possible to reach any point on the globe from any other place in a matter of hours, instead of a similar number of days by surface travel. This ability may be perverted into military power, or it may be converted into peaceful penetration by commerce and culture. Finally, the development of atomic power does not alter the truth or the significance of these facts, for the pathway of an atomic bomb will continue to be through the air, no matter how it is projected.

d. Mass Production and Technical Improvements. The military demands of the British and French forces had brought our aircraft and engine factories into mass production before our own entrance into the Second World War. Even before Pearl Harbor, America had become the arsenal of democracy, which was as fortunate for us as for our later allies. President Roosevelt called for 50,000 planes in 1940 and 100,000 more planes in 1941. Even the former year's lesser demand represented more planes than this entire American industry had produced since the Wrights' initial flight at Kitty Hawk in 1903. Using all possible facilities from the automotive industries, with their assembly lines and mass production methods, to small sheds and hastily improvised factories for making small but essential parts, the American aircraft industry became the greatest the world had ever seen, doing a record volume of 16 billion dollars' worth of business in a single year.

The qualitative aspect of this industrial miracle is as significant as its quantitative feature, for improvement is as significant as increase. Aviation has various needs, which call for many different types of planes. Compromises must be struck among the divergent goals of speed, safety, capacity, durability, and manageability. Moreover, inventions must be quickly adopted and smoothly adapted to any purpose or program. A usable but obsolete plane is no better than a broken plane. Indeed, it may be worse, because it invites continued use. In combat, an inferior plane is little better than no plane at all.

Despite our mass production methods, where possible and desirable, airplane manufacture was not standardized; experimentation was encouraged in all phases of the industry. Although vast sums were spent for facilities that were little used and for projects that were never completed, the United States did develop many types of aircraft that were distinctly superior for the particular purposes for which they were designed.

At the conclusion of the Second World War, aviation experts were planning on peacetime air forces at least ten times as great as those in existence before it. Such a program would mean an aviation industry from 10 to 15 per cent of its wartime peak, but a dozen times as great as its prewar size. In short, a considerable part of our wartime expansion in the aviation in-

dustry is to be permanent. In addition to contraction in size, there is the obvious problem of reconversion from the needs of war to those of peace. Air transportation, in contrast to that by water, is still in its infancy.

e. Merchant Aircraft. Commercial air transportation is no longer an experiment or a wild adventure. Air passengers include not only military officers and governmental officials, but also businessmen and women. Children, the sick, and the injured are flown with ease and speed.

Moreover, air transportation has ceased to be a luxury available only to the rich, to be used by ordinary people only in rare cases of great emergency. Air-line fares for long distances are now on the same level as the charges for first-class rail transportation including Pullman facilities.

For international transportation across the North Atlantic there is a comfortable seat that is adequate for a 10- to 12-hour crossing, in comparison with an ocean liner cabin to be occupied for about a week. A round trip to Europe by airplane may soon cost as little as $200, or less than tourist accommodations by water. This economy in time and money may well produce 4 million air voyages to Europe per year, with an annual tourist dollar balance against the United States of more than a billion dollars, which will help to offset our favorable trade balance. An enlarged travel market is envisioned by such a new and enhanced opportunity for people with limited time and money to visit distant places, some of which have long been familiar to the tourist, but others of which have been inaccessible by the older methods of transportation.[1]

The prospects for a huge increase in the volume of air mail are more immediate and more definite. It is possible that all long-distance, first-class mail may soon be carried by air. The air-mail tonnage of 1944 was double that of 1942, despite an increase meanwhile in the air-mail rate of letters from 6 to 8 cents, which was subsequently reduced to 5 cents. From its very inception, air-mail subsidies were important in the development of the aviation industry.

f. National Control of Air Traffic. The regulation of air transportation by the Federal government, like that of other forms of transportation, is based on its authority over foreign and interstate commerce. Whereas much motor transportation is local and intrastate in character, most air traffic is for long distances. Most civilian airports are municipal ventures, but they are managed in cooperation with the national government and the participating air lines. The Air Commerce Act of 1926 empowered the United States Secretary of Commerce to establish civil airways, to maintain navigation facilities, and to establish air-traffic rules.

The Civil Aeronautics Authority was created in 1938 to control the rapid expansion of commerce in the air, just as the Interstate Commerce Com-

[1] VAN ZANDT, J. PARKER, "Civil Aviation and Peace," Brookings Institution, Washington, D. C., 1944.

mission had been established in 1887 to regulate the increasing commerce then carried by the recently extended railroad systems. The Civil Aeronautics Board (since 1940), composed of five members, is similarly appointed by the President and approved by the Senate; each serves for a term of six years. The duties of this body are to foster and to regulate air transportation according to the needs of foreign and domestic commerce with special regard for the interests of public safety and national defense. Its functions are to promote efficient and safe air transportation at reasonable rates, to preserve competition, and to prevent discrimination. The regulation of air carriers is the central obligation of the Civil Aeronautics Board, which must approve their routes, their rates, their records, and their routines.

g. International Regulation. At the conclusion of the Second World War, international rivalry replaced the former cooperation enjoyed by the Allied powers. Significant differences in aviation policies developed between such close allies as the United States and Great Britain, the chief rivals for air supremacy. The United States had more numerous and more efficient transports, but Great Britain had more and larger territorial possessions, scattered strategically all over the world. In return for lend-lease airplanes the United States suggested the continued and unrestricted use of many British bases for commercial aviation. We were looking toward a future of expanded aviation with increased traffic at low rates in more and larger planes. Great Britain, traditionally a sea power, was more conservative in her outlook upon shipping by air as compared with that by water; she was economically unable to compete effectively in a new and expanding industry. Great Britain, therefore, was inclined toward a rather rigid international regulation of rates and frequencies of service through an international body similar to our own Civil Aeronautics Authority. The United States was more favorable toward a program of free competition and a policy of *laissez faire.*

An international conference agreed to work out a technical air code, covering the worthiness of aircraft, qualifications of pilots, rules of the road, weather reporting, communications, safety, search and rescue programs, and even procedures as to tickets and tariffs. Each nation in attendance agreed to permit the airplanes of all other nations to fly over its own territory and to land for noncommercial purposes. Special agreements on standard forms could be worked out between two nations or among many nations covering commercial stops to discharge and to receive passengers or freight. Thirty countries have already signed such agreements, enabling airplanes freely to carry traffic to and from their territory in return for similar privileges. So far, the British and Americans have failed to reach an agreement by which the airline of one country can pick up traffic in another nation and then carry it to a third country.

Nevertheless, a score of nations, including the United States, have agreed to this reciprocal privilege among themselves.

26–21. Coordination of Transportation Agencies. Competition between rail and motor transportation might well be supplanted or supplemented by greater cooperation between them. Such cooperation might take the form of a division of areas or routes, based on local needs and relative ability to meet those needs. Instead of such cooperation, however, railroad companies themselves engaged in motor transportation in active competition with existing bus and truck routes and even in competition with their own rail lines. Many of these railroads meanwhile sought permission to discontinue unprofitable lines, even where they afforded the only available public transportation service. Where traffic was light, or the rail route devious and the corresponding highway short and direct, the railroad company sometimes sought to substitute its own motor transportation for its service by rail.

A better arrangement might well be the combination of rail and motor transportation agencies, or, at least, their frank cooperation without jeopardy of antitrust action by the Federal government. Railroads could better be used for the transportation of bulky and nonperishable commodities over long distances. Trucks would be utilized to carry light, valuable goods over short distances. Again, trucks could give door-to-door service with delivery and pickup facilities to and from convenient railheads near consignor and consignee, between which rather distant points freight trains would carry the goods over existing railroads. Such an increase in railroad business might induce better and more frequent train service. It might promote fast freights to run nightly, permitting late evening collection at one railhead with promise of early morning delivery at another.

A survey of all forms of transportation, like our brief analysis of the relationship between rail and motor traffic, similarly reveals that they are complementary as well as competitive in character; it suggests that they might become even more cooperative and even better coordinated than is the case at present. Airplanes, for example, afford the fastest form of transportation, but the limitations of space and the vagaries of the weather restrict their present usefulness. They are especially well adapted for passenger service, for carrying first-class mail, and for transporting light, valuable packages for great distances in response to rush orders or emergency needs. At the other extreme is water transportation, which is the slowest but the cheapest form of conveyance. Despite the competition of the railroads described in the preceding chapter, water transportation is still used for the movement of cheap, bulky, homogenous, and nonperishable cargo, such as coal and iron ore. Between these two extremes is transportation by rail and motor, the coordination of which, as just indicated, can be im-

proved; it can also be extended to other forms of transportation such as air and water.

26–22. Character and Control of Communication. Whereas transportation is the physical movement of tangible commodities and visible people by freight and passenger services respectively, communication is the conveyance of intangible ideas, either by invisible voices or by written and code messages, either with or without the use of wires. It is obvious that communication is generally more rapid than transportation. Aviation has supplied rapid transportation to almost all places, but radio has provided almost instantaneous communication to most people.

A special constitutional provision gave Congress authority over the postal system, which was originally the chief means of public communication; it was, therefore, promptly made a public legal monopoly.

Early in our country's history, Chief Justice Marshall defined commerce to include all intercourse. Hence, the Federal government's control over interstate commerce included the regulation of communication, as well as transportation. Its authority was clearly established before the successive inventions of the telegraph, the telephone, and the radio. As explained in a previous chapter, commerce, which changes the place of things, is not to be confused with manufacture, which changes their form.

26–23. Improvements in Communication. *a. Telegraph and Telephone.* In 1844 Samuel Morse, the inventor, sent the first telegram over a line between Washington and Baltimore. It was not until 1888, however, that Federal control was finally secured over our continental system of wires. This act of 1888 vested the regulation of interstate telegraph lines in the hands of the Interstate Commerce Commission, created, as we have seen, in the preceding year for the regulation of the railroads. Such action was logical, because telegraph lines, for the most part, bordered railroad tracks, and railroad stations generally functioned also as telegraph offices. But other laws had given the Postmaster General certain regulatory powers over our telegraph system. Such division of Federal authority was conflicting and confusing.

The telephone of Alexander Graham Bell was a novelty at the Philadelphia Centennial Exhibition of 1876. Early telephone lines were short; reception was imperfect, and the service was poor as judged by modern standards. But improvements rapidly followed invention, and telephone service grew in popularity and in effectiveness. It passed successively and successfully from local to state range, from intrastate to interstate use, and, finally, from interstate to international communication. Independent telephone companies were gradually integrated with each other and combined with telegraph service.

b. Invention of Radio. The development of wireless communication presented an even greater problem in governmental control than had com-

munication by wire. Effective regulation of this new device was as difficult as it was important. Radio communication was never intrastate in scope; it immediately grew to interstate and international proportions. The Federal Radio Commission, an independent administrative agency, was organized in 1927 to distribute wave lengths among approved sending stations and to supervise programs disseminated through the air.

26–24. Federal Communications Commission. *a. Origin and Organization.* By act of Congress in 1934, the Federal Communications Commission, a body of seven members, was appointed by the President of the United States with approval of the Senate. It assumed jurisdiction over almost all forms of interstate communication except the mail, which still remained under the Postmaster General. The Federal Radio Commission was abolished; its staff and records were transferred to the new organization, which assumed its former responsibilities. Moreover, control over communication by telegraph and telephone, previously shared between the Interstate Commerce Commission and the Postmaster General, also was concentrated in it.

The Federal Communications Commission was to regulate interstate communication by wires and wireless, just as the Interstate Commerce Commission regulated interstate transportation. This new parallel agency was organized in a comparable fashion and subjected to similar regulations. Not more than four members might belong to the same political party; no member might own the securities of, or have a financial interest in, a company engaged in communication by wire or wireless.

b. Powers and Policies. The Federal Communications Commission has the following powers and responsibilities: (1) to prescribe just and reasonable charges for interstate communication services; (2) to require all companies engaged in interstate or foreign communication to file copies of their contracts with other companies engaged in similar business; (3) to investigate the management and records of companies engaged in communication; (4) to grant or withhold permission for an extension of their lines or areas of communication; and (5) to require each carrier of communication service by wire or wireless to furnish necessary information about its property to the Commission.

With regard to wire service, the Commission may, after public hearings, authorize the consolidation of two or more telephone companies, if it regards such action as mutually profitable and socially desirable. A previous chapter recounted how telephone service, like electric power and light, was at first local and limited; it was therefore formerly viewed as a competitive industry, and not as a natural monopoly of organization.

In respect to radio broadcasting and wireless communication, the Act of 1934 creating the Federal Communications Commission declared its policy to be

. . . to maintain the control of the United States over all the channels of interstate and foreign radio transmission; and to provide for the use of such channels, but not the ownership thereof, by persons for limited periods of time, under licenses granted by Federal authority.

In accordance with this statutory policy, the Federal Communications Commission has required licenses for the operation of all radio broadcasting stations except those of the United States government, which are assigned special call letters. Licenses to private parties are granted for specific and limited periods. They may be renewed on approval by the Commission; they may be revoked for disregard for, or disobedience of, its regulations. The Federal Communications Commission has authority and responsibility in the assignment of bands of frequencies or wave lengths to various stations and in approval or disapproval of the amount of power used and the schedule of time selected for broadcasts.

26–25. Concluding Word. These special problems of transportation and communication are more or less typical of all public utilities, whether national, state, or local in scope. The allied questions of valuation and rate making, which are present in each of them, are of especial significance in the study of all public utilities. The basic issues thereof and the usual approaches thereto, outlined for the railroads, can be applied with appropriate modifications to other and to intrastate utilities, such as busses and streetcar lines, which are subject to the public-service commissions of their respective states, just as great railroads are controlled by the Interstate Commerce Commission of the United States.

As most public utilities are natural monopolies of organization, competition therein is undesirable and effective social control, therefore, is imperative, whether it be by governmental regulation or governmental operation. Industrial monopolies or the trusts, however, present questions of the possibility and the desirability of dissolution. The problem here is one of the revival of competition and the repression of unfair methods of competition.

This chapter concludes our discussion of monopolies. Having treated the more materialistic problems of land and capitalistic organization in these two parts, we now move on to the more human problems of labor and the national welfare.

Guide Questions on Text

1. *a.* Show why the determination of a "fair rate" is complex.
   b. What does it involve?
2. *a.* Why is railroad valuation difficult?
   b. Compare theories of railroad valuation.
3. *a.* Explain the principle of indirect costs.
   b. Show how it is involved in the determination of railroad rates.
4. *a.* Explain the principle of joint costs.
   b. Show how it is involved in the determination of railroad rates.

5. What is meant by the upper and lower limits of railroad rates?

6. What is meant by the expression "charging what the traffic will bear"? Is it benevolent or malevolent in its implication?

7. *a.* Do you regard governmental ownership and/or operation of the railroads as inevitable? Why or why not?

b. As desirable? Why or why not?

8. Show how changes in travel habits have affected the railroads.

9. Make out a case for or against a strong American merchant marine.

10. How can our transportation agencies be coordinated under private ownership and operation? If not, what alternative?

11. Indicate functions and powers of the Civil Aeronautics Board.

12. Outline purpose, powers, functions, and organization of the Federal Communications Commission.

Topics for Investigation

1. Best basis for valuation of the railroads.
2. Social versus economic considerations in the determination of railroad rates.
3. Recent improvements in railroad transportation.
4. Important railroad reorganizations.
5. Proposal to postalize railroad rates.
6. Federal regulation of motor transportation.
7. Development of aviation in the United States.
8. Federal control over communication in the United States before and after the invention of the radio.

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See also Selected References, Chaps. XXIV and XXV.

Part Eight

PROBLEMS OF NATIONAL WELFARE

CHAPTER XXVII

PROSPERITY, PRODUCTIVITY, AND THE NATIONAL INCOME

27–1. Ideal of Economic Prosperity. Prosperity may be defined as a relative abundance of economic goods. Poverty, on the contrary, is a condition of insufficiency or scarcity.

Social welfare, like individual happiness, requires more elements than adequate income. Aesthetic ideals and ethical values also are implied. But economics is a bread-and-butter subject, and the economist confines himself to the business of getting a living. Economic prosperity, however, is basic to social welfare and personal happiness. Ordinary human beings require sufficient income to meet the physical needs of life and to conform to the social standards of the group.

Prosperity is an economic ideal in the same sense that democracy is a political ideal, virtue a moral ideal, and beauty an aesthetic ideal. An ideal is a relative term and a changing concept. Social progress in that direction is accompanied by a lifting of the particular ideal to still higher standards. Consequently, progress toward it is obscured. Thus economic progress toward an existing ideal of prosperity constantly advances that goal of material well-being. As higher planes of living are enjoyed, still higher standards are desired.

27–2. Causes of National Prosperity. Causes of national prosperity are similar to those of economic progress, for prosperity is a test and a goal of economic progress. A discussion of them involves a review of all factors of production.

The primary agents of production are land and labor. A rich geographical environment, occupied by an intelligent and industrious people, is conducive to national prosperity, provided the population is not too dense. Economic progress is conditioned also by the accumulation of a social surplus of durable economic goods, by an advance in the arts of production, and by an improvement in social institutions.

The material well-being of our industrial civilization is due chiefly to a favorable ratio of population to natural resources and to the substitution of power machinery for hand tools and of modern technology for primitive handicrafts. In short, the Industrial Revolution made possible our transition from a past deficit economy of pain to the present surplus economy of pleasure. The so-called "problem of overproduction" or surplus com-

modities and enforced leisure in the unpleasant form of unemployment have replaced the former problems of insufficient goods and excessive hours of exploited labor.

27–3. American Prosperity. In spite of recurrent depressions and persistent poverty, the United States is a relatively prosperous nation. Nature has been very bountiful to us; our physical environment has valuable and varied resources. Moreover, the population of America is not so dense as that of Europe and Asia.

Although waste and exploitation have occurred, utilization of our resources and adaptation by our people have been fairly satisfactory. Our inventive genius and capacity for industrial organization are famous. Productivity per acre is higher in other countries that practice a more intensive cultivation of their land, but productivity per man is higher in the United States than in most other portions of the world.

27–4. High Productivity Essential to Great Prosperity. Supply and demand are related in that consuming power comes ultimately from production, and, in the long run, improved production permits increased consumption. Higher planes of living therefore are promoted, not menaced, by mechanical inventions and industrial improvements. On the other hand, long-continued strikes and widespread destruction of wealth, in order to raise wages or prices, reduce the real national income of our people. Restriction of output operates in the same negative fashion. If a conflict of interests among different groups results in a curtailment of production, the national income is reduced and planes of living are lowered.

27–5. Equitable Distribution Also Essential to Prosperity. Individual planes of living, however, do not always improve promptly or proportionately with an increase in industrial production. In this land of plenty, even in periods of so-called "prosperity," some families live in dire poverty. Many workers suffer severely from unemployment in economic depressions. In short, our prosperity has been unevenly diffused throughout our population and irregularly distributed over periods of time. It has been honeycombed by inequality and harassed by instability.

The depression years from 1929 to 1933 demonstrated that American prosperity was instable and spotty in character. Although the United States had increased production, it had not proportionately or simultaneously expanded distribution. Truly it is an uncertain or ill-digested prosperity that is unable to consume its own huge output because of a maldistribution of purchasing power among the masses of people and because of instability of income over periods of time.

27–6. Distinction between Wealth and Income. Economic wealth includes all goods having materiality, utility, scarcity, and transferability. It is the stock of economic commodities in existence at a particular time. Income, on the other hand, is a flow of commodities and services over a

definite period of time. Wealth is a source of income; and income is the product or yield of wealth, worked on by labor.

To use a familiar illustration, a cow is wealth, but her milk is income. Again, wealth may be compared to a reservoir of water, and income to the stream flow into it or the pipe flow out of it. "Killing the goose which lays the golden egg" is a simple way of saying that the destruction of wealth or capital prevents the future yield of income from it.

It is obvious that great inequalities exist in the ownership of this huge stockpile of economic commodities called our national wealth. It is equally apparent that the stream of national income flows irregularly and spasmodically; it also divides itself unevenly into branches of different size. To some individuals, in good times, come shiny automobiles, fine clothes, and other luxuries; whereas to other families come merely the bare necessities of life.

This distinction between wealth and income is important in public finance. Income taxes are based on the flow of commodities and services in the form of wages, salaries, rent, interest, and profits enjoyed during a calendar year. On the other hand, the general property tax is based on the value of the wealth, real or personal, owned by an individual at the time the assessment is made.

27–7. Composition of National Wealth. It is easy to define wealth and income and to draw a glib distinction between them. But the application of these generalities to particular problems is difficult, as can be seen in an attempt to appraise the national wealth and income of the United States. The same things are not economic wealth among different peoples and even within the same nation over a long period of years. Water is a free good to most of us, but land is not. On the other hand, the reverse might well be the situation among nomadic tribes in the Sahara Desert.

As population increases, natural resources, such as timber, develop scarcity and acquire value. What were formerly regarded as free goods become economic goods. The legal institution of private property is extended to protect their owners. Hence the paradox of wealth. As we become poorer in some forms of physical wealth, we become richer in their pecuniary values. This difficulty must be recognized by students of economics who would measure the increase or decrease in our national wealth over a period of time. Thus an increase in monetary value, as revealed by various census estimates, is due, in part, to the fact that some forms of wealth have increased in value while their physical stock has been depleted.

The reverse is equally true. In a year of bumper crops farmers may receive less money for more produce than in former years when food was scarce but high.

27–8. Composition of National Income. It is similarly difficult to determine just what items should be included under the term "income." A moot

point is the matter of savings. Should savings be regarded as a flow of income, or as an increase in wealth, or both? If regarded as income, should savings be measured when made or when consumed, or at both times?

Numerous services are self-created, and many commodities are homegrown or homemade. Hence, some income must be imputed, while other income can be computed. We cannot say that a farmer and his wife who live on their own land and who consume their own produce are any less income-producing and income-consuming merely because their commodities and services do not go through the market and hence fail to register under our price system.

27–9. Difficulties in Measurement of National Wealth and Income. Measurement of the national wealth and income is even more difficult than their definition. The national wealth includes public goods, as well as economic goods and free goods. Some of these public goods, such as roads, are economically productive; but others, such as battleships, are destructive. Necessary or unnecessary, desirable or undesirable, they do not yield individual incomes.

An increasing portion of the national income goes into collective consumption, which is represented by such divergent governmental services as furnishing aids to transportation or means of protection, illumination, or education. Although important, should these items be regarded as parts of the national income? If so, how can these different types of service be appraised in dollars? Even though their cost figures are accepted, should they be added at the time of production or distributed over the period of consumption?

Part of the national income goes into the formation of consumption goods, but another portion merely replaces capital goods that have been used for further production, rather than for immediate and direct consumption. Again, constant care must be taken to avoid duplication of the same items that may reappear in various forms as they go through our roundabout process of production. Iron ore, for example, becomes pig iron, which is used to make steel, which, in turn, is fashioned into motor cars. Coal, on the contrary, is consumed in the manufacturing process. Correct appraisal would be concerned with the net value added, and not with the gross volume of production. Due allowance must be made for commodity turnover and for the replacement fund of industry, or the national income will be exaggerated far beyond its true size.

It is important that real income be distinguished from monetary income. Any estimate of the national wealth or income over a period of years must be refined for changes in the general price level. The increase or decrease either in wealth or in income, as expressed in dollars, may be apparent rather than actual, owing to changes meanwhile in the purchasing power of

money. Real income is a flow of commodities or services for which dollars have been merely the current medium of exchange or fluctuating standard of value.

Finally, changes in our national income should be refined for changes in population, as well as for changes in prices. Per capita income is more significant than total income. It should always be remembered, however, that average income is not actual income. Because of economic inequality and instability, national prosperity does not guarantee individual prosperity to all people at all times, even though the total income in the long run is great enough to afford decent planes of living for all families.

27–10. Growth of Our National Income. The pioneer study of the national income of the United States was that made by Dr. W. I. King, working under the auspices of the National Bureau of Economic Research.[1] He concluded that the real per capita income of our people, as expressed in terms of a constant, namely, the average price level from 1890 to 1899, had increased from $69 in 1850 to $262 in 1910. Apparently, the average per capita real income of the people of the United States had increased fourfold during this period of 60 years. Although some of this expansion of the national income can be explained by our transition from a subsistence economy to one of exchange, making for more complete recording, much of it was due to an increase in industrial production.

A subsequent analysis[2] of our national income by Dr. King studied the two following decades even more carefully; it covered the 20 years before the stock-market crash of 1929. His later findings indicated that the total national income, including imputed income for commodities and services not exchanged, as expressed in current dollars, tripled, rising from 30 billion dollars in 1909 to 89 billion dollars in 1928. When refined for changes in the purchasing power of the dollar, the real, national income of the United States nearly doubled in this same 20 years, rising from 31 billion dollars in 1909 to 54 billion dollars in 1928, using constant dollars of 1913 purchasing power. Refining these estimates for changes in population, per capita national income in current dollars more than doubled, rising from $327 in 1909 to $749 in 1928; per capita real income increased by one-third, rising from $346 in 1909 to $452 in 1929, as expressed in constant dollars of 1913 purchasing power.

27–11. Later Changes in National Income. These investigations of income by the National Bureau of Economic Research, begun by Dr. King, were continued by Dr. Kuznets. Their method of computation differed somewhat and the periods studied overlapped. Table 17 gives the annual national income from 1919 to 1938, expressed in current dollars, in constant

[1] King, W. I., "Wealth and Income of the People of the United States."

[2] King, W. I., and Lillian Epstein, "The National Income and Its Purchasing Power."

dollars of 1929 purchasing power, and in percentages of the average annual real income for the total period.

Except for the minor depression of 1921 with its commodity-price deflation, the national income of the United States expanded steadily during the prosperous twenties. Total national income in current dollars increased from 64 billion dollars in 1919, the first postwar year, to 82 billion dollars in 1928, the last year before the stock-market crash of 1929. Even more convincing evidence of the prosperity of this decade was the revelation that our total national income in constant dollars of 1929 purchasing power rose from 57 billion dollars in 1919 to 81 billion dollars in 1928. It seems reasonable to believe, therefore, that from the conclusion of the First World War, or, at least, from the minor depression of 1921, to the inception of the major depression in 1929, a period of relative prosperity and stability in commodity prices, the total national income of the United States, real as well as monetary, increased by about one-third.

TABLE 17. NATIONAL INCOME OF THE UNITED STATES,* 1919–1938

Year	Billion current dollars	Billion 1929 dollars	Per cent average annual income	Year	Billion current dollars	Billion 1929 dollars	Per cent average annual income
1919	64.2	57.0	81.4	1929	87.2	87.1	124.4
1920	74.2	58.4	83.5	1930	77.3	79.9	114.2
1921	59.4	56.5	80.7	1931	60.3	69.3	99.0
1922	60.7	60.8	86.9	1932	42.9	55.6	79.5
1923	71.6	70.7	101.0	1933	42.2	56.7	81.0
1924	72.1	71.7	102.4	1934	49.5	62.1	88.8
1925	76.0	73.9	105.6	1935	54.4	65.6	93.7
1926	81.6	79.0	112.9	1936	62.9	75.0	107.2
1927	80.1	79.6	113.8	1937	70.5	80.8	115.4
1928	81.7	81.1	115.8	1938	65.5	79.0	112.9

* KUZNETS, S., L. EPSTEIN, and E. JENKS, "National Income and Its Composition, 1919–1939," p. 137.

The V-shaped picture of the thirties, a decade of depression and recovery, is very different. The national income of the United States dropped from a 1929 peak of 87 billion dollars to a 1932–1933 valley of 42 billion dollars in current dollars, or from a 1929 crest of 87 billion dollars to a 1932–1933 trough of 56 billion dollars in constant dollars of 1929 purchasing power. In other words, our total monetary income fell to one-half, and our total real income to two-thirds their former levels.

From these depths of depression, our national income, expanded by public work and relief, increased by about one-half during the first five

years of the New Deal. It rose from a 1932–1933 valley of 42 billion dollars to a 1937 peak of 71 billion dollars in current dollars or from a 1932–1933 trough of 56 billion dollars to a 1937 crest of 81 billion dollars in constant dollars of 1929 purchasing power. The 1937 level, however, was still below the former peak of 1929, both in constant and in current dollars.

The following year, 1938, experienced a recession, in which our total monetary income dropped sharply and our total real income declined moderately. In the autumn of the next year, 1939, the Second World War broke out. This great conflict, we shall now see, brought momentous changes in the volume and character of the national income of the United States.

27–12. National Income during the Second World War. *a. General Increase.* The national income of the United States during the next few years was greatly influenced by the Second World War. The period from 1939 to 1943, inclusive, was studied by Dr. Kuznets. His findings, a sequel to his earlier survey, are stated in Table 18. The annual national income

TABLE 18. NATIONAL PRODUCT—WARTIME CONCEPT *

(Current prices in billion dollars)

	1939	1940	1941	1942	1943
1. Flow to consumers	64.8	68.8	77.7	85.1	94.1
2. Nonwar capital formation:					
a. Gross	13.2	16.7	20.9	8.8	2.7
b. Net	6.0	9.3	13.0	0.1	−6.5
3. War output:					
a. Gross	1.4	2.8	12.8	50.3	81.3
b. Net	1.4	2.8	12.5	49.5	79.5
4. National product:					
a. Gross (1 + 2*a* + 3*a*)	79.4	88.3	111.4	144.2	178.1
b. Net (1 + 2*b* + 3*b*)	72.2	80.9	103.2	134.7	167.1

* KUZNETS, S., "National Product in Wartime," p. 36, National Bureau of Economic Research, New York, 1945.

is given, and each total is broken down into consumers' goods, nonwar capital formation, and war output.

Although comparable estimates for some recent years are not at hand, other studies indicate that the peak of production was reached in 1944, and that it was maintained at that high level until victory was achieved in 1945. Then followed a year of reconversion and industrial disputes, but production and employment recovered in 1947, when they were well above their wartime peaks, as measured in current dollars.

Under the duress of the Second World War, according to Dr. Kuznets, the gross national income of the United States, expressed in current dollars, rose from 79 billion dollars in 1939 to 178 billion dollars in 1943; the net national income in current dollars increased during the same period from 72 billion dollars to 167 billion dollars. Because of price controls imposed, inflation was not so great during the Second World War as it had been during and immediately after the First World War. Consequently, most of this increase in total monetary income represented an expansion of real income.

Other studies also point to the startling conclusion that the real national income of the United States doubled from 1939 to 1943. Confirmation of this conclusion can be found in the index of industrial production, prepared by the Federal Reserve Board of Governors, which rose from its prewar base of 100 per cent for the 1935 to 1939 average to a 1943 peak of 239 per cent. With the advent of victory abroad, followed almost immediately by strikes at home, this index fell to about 160 per cent in 1946, but it rose somewhat the following year with an improvement in industrial relations.

b. Changes in Composition of National Income. Breaking down this wartime increase in industrial production and the comparable or consequent expansion of our national income, it is apparent that most of it is to be accounted for by war output, which rose from 1.4 billion dollars in 1939 to 81.3 billion dollars (gross) or 79.5 billion dollars (net) in 1943. This sixtyfold increase in war output was phenomenal and unprecedented. At its peak in 1943, our national war output was equal to, or even greater than, our total national income for most prewar years. Although representing real income and constituting half the total national income in 1943, these goods were instruments of destruction, which were neither implements of production nor enjoyables for consumption. The moralist can debate the philosophical question of whether this was true or false prosperity. The economist can speculate about what our wartime industrial production revealed about America's capacity to produce, were it converted from tanks to tractors and diverted from bombing cities to building houses.

As indicated by Table 18, nonwar capital formation expanded generously from 1939 to 1941, *i.e.*, in the period immediately before Pearl Harbor, but it contracted sharply in the following years, when American industry was forced by our own entrance into the war to convert from the manufacture of automobiles and electric refrigerators to the making of warplanes and battleships. Gross nonwar capital formation in current dollars first increased from 13.2 billion dollars in 1939 to 20.9 billion dollars in 1941 and then decreased to 2.7 billion dollars in 1943. What was even more significant, net nonwar capital formation first expanded from 6 billion dollars in 1939 to 13 billion dollars in 1941; then it almost ceased to exist, falling to 0.1 billion dollars in 1942; finally, net capital formation was suc-

ceeded by net capital depletion in nonwar industries, reaching in 1943, two years before the conclusion of the war, a deficit figure of 6.5 billion dollars. The immediate postwar period, therefore, faced the grave problem of capital replacement, as well as that of industrial reconversion. It also presented opportunities for consumers to secure some previously unobtainable goods, although it took a long time to refill the pipe lines of peaceful industry, particularly in the case of durable goods.

The flow of commodities and services to consumers rose steadily from 64.8 billion dollars in 1939 to 94.1 billion dollars in 1943. Despite popular opinion to the contrary, the American people as a whole consumed more goods during the war than they had before the war, even though certain types of goods were in short supply. The character of consumption changed with industrial conversion, but its volume expanded. Consumables in current dollars rose by almost one-half from 1939 to 1943. Even allowing for increased costs of living, and refining monetary consumers' income for changes in the general price level, the real consumption income of the American people as a whole shrank little, if any, during the Second World War. Indeed, it probably increased moderately. To be sure, the incidence of this income, like the character of production and consumption, was altered. Some groups, especially people on salaries and others with fixed incomes, suffered sharp reductions in their customary planes of living, while still other and larger groups enjoyed increased incomes and higher planes of living. Price control and the rationing of certain commodities slowed down the inflationary spiral of mounting costs of living; they also promoted a wider and fairer distribution of scarce and necessary articles.

27–13. National Income Is Net Current Production. Because our national income really consists of the total, net, current production of all our people, there must be a correlation between, if not a complete identity of, income and production. This can be seen in Chart 11, which traces the movements of our national income and our industrial production from the First World War through the Second World War. The national income figures are those of Dr. Kuznets; they are stated in billions of current dollars. The industrial production index (Table 19), unadjusted for seasonal variations, is that of the Federal Reserve Board; it is expressed in percentages with the 1935 to 1939 average as base, or 100 per cent. There is no adequate index of total production. Because our production index is limited to manufactures and to percentages of physical output, whereas the income figures are totals given in billions of current dollars, only a rough correlation can be expected. Nevertheless, the general pattern, which is that of the business cycle, is the same in both cases, although the time and degree of change vary.

Chart 12 pictures the growth of our national income during and immediately after the Second World War, as indicated by the President's Economic

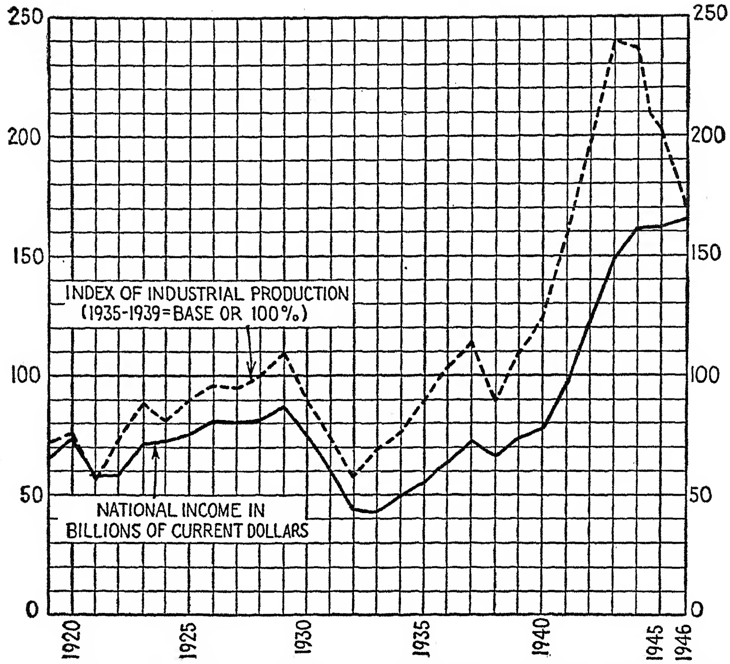

CHART 11. National income and industrial production from the First World War through the Second World War.

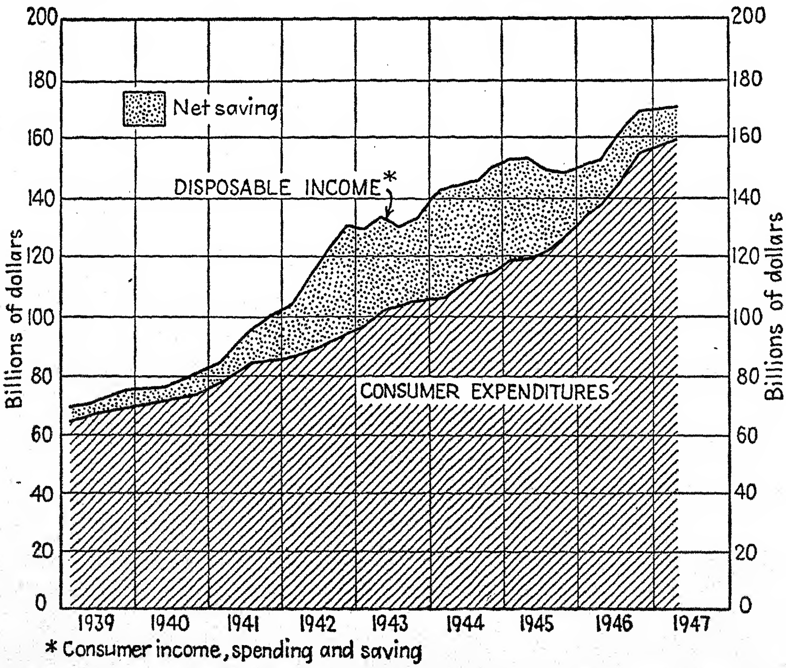

CHART 12. Recent growth of our national income. (*Data from the President's Midyear Economic Report to Congress, 1947. Chart adapted from The New York Times, Sunday, July 27, 1947.*)

Report to Congress at midyear, 1947. According to this survey, national income in current dollars almost tripled, allowing some saving, despite

TABLE 19. PHYSICAL VOLUME OF INDUSTRIAL PRODUCTION *

(Base or 100 per cent is average of 1935–1939) †

Year	Index	Year	Index	Year	Index
1919	72	1929	110	1939	109
1920	75	1930	91	1940	125
1921	58	1931	75	1941	162
1922	73	1932	58	1942	199
1923	88	1933	69	1943	239
1924	82	1934	75	1944	235
1925	90	1935	87	1945	203
1926	96	1936	103	1946	165
1927	95	1937	113	1947	176
1928	99	1938	89		

* Federal Reserve Bulletin.
† Unadjusted for seasonal variations.

the drain of the war. In the postwar period, however, the percentage of rising personal incomes saved began to decline as the cost of living rose.

27–14. Types of Prosperity. *a. True and False.* True prosperity consists of a relative abundance of economic goods, which have either usefulness for production or utility in consumption. False prosperity, on the contrary, is an abundance of military weapons, or implements of destruction. Although the national income of the United States almost doubled during the Second World War, this great increase in commodities and services, of necessity, took the perverted form of war goods. Hence, it was false and not true prosperity. Paradoxically speaking, it was increased production for improved destruction.

This great emergency, nevertheless, revealed America's tremendous productive capacity and its remarkable industrial flexibility. If the resultant gains and technological improvements can be utilized as effectively in the arts of peace as they were by the ardors of war, the planes of living of all people can be raised to still higher levels. Removal of the strain of war and the menace of violent death will permit the increased leisure from shorter hours of work to be devoted to the realization of the more abundant life.

b. Real and Artificial Prosperity. Real prosperity is brought about by an actual increase in the physical volume of production, whereas artificial prosperity is stimulated by rising prices or inflation. Real prosperity is

attested not by an expansion of money or credit but by an abundance of economic goods with which to gratify human wants. The artificial prosperity of inflation is as deceptive to an ignorant person as the flushed face of an unhealthy individual suffering from fever or high blood pressure and approaching physical collapse. Similarly, inflation may be followed by a financial crisis with subsequent deflation and depression.

27–15. New Industrial Revolution in America. The total volume of production and the rate of productivity per man-hour so increased in this country during and between the two world wars that the United States may be said to have experienced a new industrial revolution and to have emerged as the world's greatest industrial power.

Direct causes of this increased productivity have been the rapid invention of new machinery, the discovery of new sources of power, and continued improvements in industrial processes. Indirect causes have been general economic advances, such as the extension of economic and educational opportunities. Although a strong argument for the capitalistic system of private enterprise, its critics have pointed to the fact that this great increase in production has been marked by recurrent depressions and marred by persistent poverty. Most impartial students, however, agree that the chief secret of the so-called "new industrial revolution" lies in the rapid growth of acquired knowledge in the form of improved industrial techniques, in the great accumulation of such capital instruments as power machinery, and in the fuller and better utilization of various forms of mechanical energy.

In this superior adaptation to our physical environment, scientific discoveries have been basic. Their practical utilization by the common people has been prompt and popular. The inventive genius of the Yankee has been conspicuous and ubiquitous. American laborsaving devices are famous and familiar the world over. The automatic cotton picker is a late example in a long series; it may be as significant for the future as was Eli Whitney's cotton gin in the past.

Recent developments in industrial chemistry are equally momentous: plastics and stainless steel, multiple-purpose glass, paper from cornstalks and silk from wood fiber, synthetic rubber and improved motor fuels, to mention only a few of these modern marvels. Great industries are actively seeking inventions and improvements in their scientific laboratories. Trained specialists continuously experiment with new methods and test various materials and devices. They do not wait passively for discoveries to be made or inventions to occur to some ingenious operator on his repetitive job. The General Electric Company, for example, established its "House of Magic" for experimentation in practical physics, and the DuPont Company proudly announced its slogan, "Better Living through Chemistry."

The productivity of a free American worker is many times that of a Greek slave. That ancient laborer toiled with his bare hands or, at the most, with a few simple tools, whereas the modern operator merely guides the tireless giant of power machinery. A miller working with rough stones from dawn to dark in the Golden Age of Pericles could grind only one barrel of flour a day, but a large mechanized factory in Minneapolis now daily produces thousands of barrels of flour. Similarly, a medieval scribe took months to copy a single manuscript, whereas a modern printing press rolls off hundreds of copies of a popular book in a few hours.

The invention of power machinery and improvements in industrial processes have been continuous since the advent of the factory system during the old Industrial Revolution in England almost two centuries ago. The process has been accelerated and the movement has gathered momentum during the new industrial revolution in the United States. Inability to adjust our social organization with commensurate speed and comparable efficiency has created a maladjustment, currently known as a "culture lag." It culminated in the great depression of the early thirties.

Increased mechanization of industry necessitated expansion of the business unit and intensification of division of labor. The holding company or the super corporation supplanted the earlier and smaller joint stock company. Repetitive tasks were substituted for general occupations as the machine operator on an assembly line replaced the craftsman on custom work. The preceding part of this text explained how large-scale manufacture was followed by large-scale management. Finally, mechanization and standardization reached their climax in mass production, so well illustrated by the automobile industry. Indeed, mass production occupied a place in the new industrial revolution similar to that of the factory system in the first Industrial Revolution. It was largely responsible for the tremendous increase in manufacturing output during the Second World War.

Just as the noisy, dirty steam engine personified the early phases of the Industrial Revolution in England, so the quiet electric motor and the clean hydroelectric turbine personify the silent power of the later industrial revolution in the United States. The cheap and efficient transmission of electricity is now revolutionizing city and farm, home and office, and manufacture as well as transportation. It has been said that, whereas steam power was the enemy of the home, electric power is its friend. Electricity and the electric motor may stimulate the future decentralization of light industries, just as the steam engine necessitated the past concentration of the heavy industries. Thus, there have been two opposing forces, namely, centralization and decentralization, in industry.

27–16. Potential Capacity and Actual Production. In spite of the technological progress of the new industrial revolution, there has persisted a wide gap between America's potential capacity and her actual production.

This gap was widened by the ravages of the great depression. It was closed by the industrial emergency of the Second World War.

Studies of America's capacity to produce and to consume were made by the Brookings Institution. The conclusions are given in the following paragraph.

> Making scientific allowance for climatic factors in the flow of materials and the demand for products, for breakdowns and other normal interruptions, for the availability of labor, etc., it was found that throughout agriculture, manufacturing, mining, and other branches of industry, the practical productive capacity of the country in 1929 has been substantially greater than the capacity actually utilized. The percentage of utilization in that year was, on the average, 80 per cent—running from 45 per cent of practical capacity in the locomotive industry to 92 per cent in the full-fashioned hosiery industry. . . . Roughly speaking it was found that the country could have produced 20 per cent more than it did in 1929—or ninety-six instead of eighty-one billions of dollars worth. And it was further found that the proportion of non-utilization had remained fairly constant over the thirty years preceding. The 1929 performance, moreover, was that of the productive mechanism at its best. At its worst, in 1932, the volume of goods and service produced was about one-third less than the production of 1929.[1]

27-17. Adequacy of Our National Prosperity. The adequacy of our prosperity can be tested by dividing the national income or the total volume of consumers' goods among all the individuals or families in this country. In spite of yearly fluctuations in the size of the national income, our annual per capita money income, or our national income per family, has generally kept ahead of the costs of maintaining a minimum standard of living. Hence it would seem that the national income of the United States has been large enough to abolish poverty, unless production is curtailed by a serious depression, or diverted by overinvestment in capital goods, or perverted by war into weapons of destruction. But every individual or each family must live on his or its own actual income, be it large or small, and not on a mathematical average. No matter how correct the statistical analysis may be, the average per-family national income cannot be drawn against to buy bread and butter for a real family.

Although the national income of the United States generally has been large enough to permit a decent standard of living to be enjoyed by all workers, and even by all families under the assumption of one breadwinner per family of four or five, the average wage per family before the Second World War was inadequate to permit the maintenance of an American standard of living on the basis of one breadwinner to each family. Hence the families of many wage earners were living in poverty, or the wages of the head of the house were supplemented by the earnings of women and children. The next chapter will discuss the issue of maldistribution, or

[1] Moulton, Harold G., Economic Progress without Economic Revolution, *Fortune Magazine*, Nov., 1935.

economic inequality; and the succeeding one will treat the problem of poverty, or economic insufficiency.

27–18. Limitations of Present Prosperity. Perhaps a final word of caution is necessary. Although the equal division of the national income might temporarily raise all families out of what is regarded as poverty, it would not permit the popularization of conspicuous consumption. Nor would it permit the multiplication of leisure time without some sacrifice of economic well-being. The utopian dream of some visionaries, from Brook Farm to technocracy, that an equal division of the national income would permit all individuals to live in comparative luxury and leisure is neither logical in its theoretical inference nor correct in its factual basis. Progressive standards of living are conditioned by constantly increased production. Although the repetition of this theme song of the present chapter may be tedious to the reader, certain national programs, union policies, and industrial practices that have sought to promote national prosperity or private profits by curtailment of production indicate the necessity of further education in fundamental economics.

With continued mechanization and constantly improved processes, industrial productivity may increase so rapidly that more goods than formerly can be turned out in spite of a reduction in the length of the working day. But at any particular time and in a given state of the arts, economic well-being must choose between increased production and increased leisure or a judicious sharing of the two. As prosperity depends on production, so a decrease in production is a direct threat to national prosperity.

Economic well-being is a problem of maldistribution, as well as one of insufficient or irregular production. Inadequate standards of living result not only from inefficient methods in industry, inadequate utilization of plant facilities, and instability in production, but also from extreme inequalities in the distribution of the national income.

It does not follow, however, that communism or equality of income would ensure permanent prosperity. The per capita or per family division of the national income was suggested merely to obtain a theoretical average, in order to test the adequacy of our national income to maintain a decent standard of living for all people. Although the institution of private property has permitted the perpetuation of economic inequalities, it has acted also as a spur to increased productivity. Rash changes in distribution, which savor of confiscation, might result in so great a decrease in the national income that a lowering, instead of a raising, of planes of living might take place.

Guide Questions on Text

1. What do you understand by economic prosperity as a social ideal?
2. *a.* Distinguish between wealth and welfare.
   b. Between wealth and income.

3. What factors make you skeptical of all estimates of national wealth?
4. Distinguish between real and monetary income.
5. What is the best measure of economic prosperity? Why?
6. What evidence is there to show that our national income was increasing before 1929? Indicate the necessary statistical refinements.
7. What happened to the national income produced and paid out from 1929 to 1932?
8. Indicate quantitative and qualitative changes in the national income during the Second World War.
9. What do you understand by the recent industrial revolution in the United States? Is the term a fair one? Why, or why not?
10. What do you regard as the basic factors in an explanation of the economic prosperity of the United States?
11. Why is the business cycle a serious labor problem?
12. How would you determine the adequacy of the national income to permit decent standards of living to be enjoyed by all families? What are your conclusions?
13. Distinguish between real and artificial prosperity; between true and false prosperity.
14. Distinguish between production and productivity.

Topics for Investigation

1. National wealth of the United States and that of other countries.
2. National income of the United States and that of other countries.
3. Methods of computation and imputation used by the National Bureau of Economic Research in its studies of the national income.
4. Increase in industrial production from 1914 to 1929.
5. Industrial production and productivity during the depression.
6. Production under the National Industrial Recovery Administration and that under the Agricultural Adjustment Administration.
7. Industrial production during the Second World War.
8. Prosperity panaceas.

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CHAPTER XXVIII

THE CHALLENGE OF MALDISTRIBUTION OR ECONOMIC INEQUALITY

28–1. Causes of Social Unrest. Discontent is engendered by the following: (1) economic *instability*, indicated by the business cycle; (2) economic *inequality*, called maldistribution; (3) economic *insufficiency*, in the form of poverty; and (4) economic *insecurity*, illustrated by unemployment. These four economic I's mar our national prosperity and menace the capitalistic system.

The preceding chapter sketched the growth of the national income of the United States; it stressed our increasing productivity. This chapter will consider the division of the national wealth and the distribution of our national income among all the people of this rich country; it will examine the charge of economic inequality. The following chapter will treat the problem of economic insecurity.

Great wealth and glaring want have made a striking contrast in democratic America. Poverty has persisted in spite of increased productivity. Periods of prosperity have been followed by economic depressions, as the business cycle has run its erratic course. In short, American prosperity has been limited to particular periods and to certain groups. Although money wages, and even real wages, have been higher in the United States than in most European countries, social insurance against economic insecurity has been more extensive abroad than at home. Again, economic extremes have not been so great there as here.

Conservative trade unionists accept capitalism and the wage system, but they strenuously attempt to raise their planes of living by various weapons of collective bargaining. Socialists and syndicalists, however, contend that serious economic inequality is inherent in any economy of individual enterprise; they seek the elimination of capitalism either by evolutionary or by revolutionary methods. Still other critics of our present economic order hold that the house of capitalism should be repaired, but that it need not be rebuilt. They would retain the basic institutions of competition, individual enterprise, and private property, but would restrict the right of inheritance and extend the principle of progression in the taxation of large incomes.

28–2. Unequal Division of Our National Wealth. One of the first careful studies of the ownership of the national wealth of the United States was

that made by Dr. W. I. King. His conclusions were based on a fairly extensive survey of decedents' property in two typical states, namely, Massachusetts and Wisconsin. These conclusions are pictured in Charts

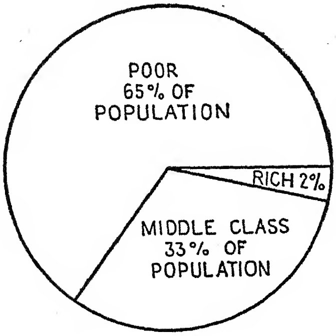

CHART 13*a*. Division of population according to wealth in the United States in 1927. According to 1927 estimates of Dr. King, rich group includes individuals owning $50,000 or more wealth; middle class includes individuals owning from $3,500 to $50,000 of wealth; poor includes individuals owning less than $3,500 of wealth.

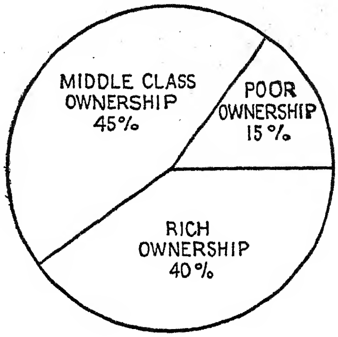

CHART 13*b*. Division of wealth according to population in the United States in 1927. According to the 1927 estimates of Dr. King, rich individuals (2 per cent of population) own 40 per cent of the national wealth; middle classes (33 per cent of population) own 45 per cent of national wealth; poor individuals (65 per cent of population) own 15 per cent of the national wealth.

13*a* and 13*b*. Dr. King summarized his findings shortly before the crash of 1929 as follows:[1]

The "rich," 2 per cent of the people, owning $50,000 or more of wealth, own 40 per cent of the total wealth of the country.

The "middle class," 33 per cent of the people, owning from $3,500 to $50,000 of wealth, own 45 per cent of the total wealth of the country.

The "poor," 65 per cent of the people, owning less than $3,500 of wealth, own 15 per cent of the total wealth of the country.

28–3. Uneven Distribution of Our National Income. *a. Before New Deal.* Let us now see how the national income of the United States was distributed at the time that Dr. King made his pioneer study of the division of our national wealth. The annual reports of the Treasury Department give us authoritative information concerning the incomes of individuals, but they are limited to those making tax returns.

For 1928 slightly over four million individuals, or about one-tenth of all those gainfully employed, filed tax returns, which were compulsory for married people receiving over $3,500 and single people making over $1,500

[1] KING, W. I., Wealth Distribution in Continental United States, *Journal of the American Statistical Association*, June, 1927.

in that year. Within this relatively small group of individuals who filed income-tax returns for 1928, over one million, or about 25 per cent of those filing returns, reported incomes under $2,000; almost two million, or about 50 per cent of those filing returns, reported incomes under $3,000; and over three million, or about 75 per cent of those filing returns, reported incomes under $5,000. Total incomes reported by these three million individuals receiving less than $5,000, and constituting three-fourths of the total number of individuals reporting incomes for that year, amounted to slightly less than one-third of the total income reported by all individuals.

At the other extreme, 511 individuals in 1928, as compared with only 152 in 1918, reported annual incomes of 1 million dollars or more; almost 1,500 individuals in 1928, as compared with only 521 in 1918, reported annual incomes of $500,000 or over; and about 16,000 individuals in 1928, as compared with only 7,500 in 1918, reported annual incomes of $100,000 and over. Although this last group of individuals receiving annual incomes of $100,000 or more constituted less than half of 1 per cent of the entire group of individuals paying income taxes for 1928, they received about 18 per cent of total individual incomes for that year.

This evidence seems to indicate that economic inequality was a problem of grave and growing significance in the prosperous decade before the crash of 1929. The growth of large fortunes apparently had accompanied the expansion of our national income described in the preceding chapter. The great increase in the industrial production of the United States had not been disseminated proportionately, nor had it been stabilized permanently. Let us now see the effects of the great depression on the subsequent distribution of the national income of the United States.

b. Income Distribution during New Deal. Whereas for 1928 about 4 million individuals filed income-tax returns, for 1935 about 4.5 million individuals did so. This was due to the fact that exemptions had meanwhile been reduced for married people from $3,500 to $2,500 and for single people from $1,500 to $1,000. But even with this broadening of the base of taxation, the proportion of individuals filing income-tax returns for 1935 was still only one-tenth of the total number of all gainfully employed people.

Within the relatively small group of individuals who filed returns for 1935, over 2 million, or about 45 per cent of all income reporters, received incomes under $2,000; over 3 million, or about 70 per cent of them, reported incomes under $3,000; and about 4 million, or 90 per cent, reported incomes under $5,000. The effects of the depression were revealed in the greater number and larger proportion of people in the lower income groups in 1935, as compared with 1928.

The total incomes reported by the 4 million individuals receiving incomes under $5,000 and constituting 90 per cent of all individuals reporting incomes for 1935 represented only 60 per cent of the total amount of all in-

dividual incomes reported for that year. Although still disproportionate, distribution was less so than formerly to the extent that in 1928 individuals with incomes under $5,000 had made up three-fourths of the whole group of income reporters, although they had received only one-third of the total amount of income reported.

The half million individuals who received $5,000 or over in 1935 were only 10 per cent of the total number of individuals reporting income for that year, but they received, nevertheless, over 40 per cent of the total amount of income reported by all individuals. Individuals receiving $5,000 or more in 1928 had made up one-fourth of all individuals reporting incomes, and they had received two-thirds of all individual income reported for that year. It is obvious that this fortunate group was smaller both relatively and absolutely in 1935 than in 1928, but it is highly significant that its share of the smaller total income did not decrease in proportion to its relative numerical decline. In other words, there were fewer people receiving $5,000 a year or more and their incomes were smaller, but within that group the per capita share of the smaller total income was larger.

In 1935 there were only 41 individuals, instead of 511, as in 1928, who reported annual incomes in excess of 1 million dollars; 150 individuals, instead of almost 1,500, who reported incomes of $500,000 or more; and slightly over 2,600 individuals, instead of almost 16,000, who reported annual incomes in excess of $100,000. The ravages of the great depression had sharply reduced the number of individuals in the higher income brackets. Between 1928 and 1935, many large fortunes had been dissipated; economic inequality had decreased.

c. Income Distribution during the Second World War. The fiscal necessities of this great conflict, as explained in the chapters on public finance, increased Federal expenditures and expanded the national debt even more than had the public work and relief programs of the New Deal. After Pearl Harbor income-tax rates were increased and the taxpaying group was enlarged. A short form (1040A) was provided for optional use in reporting incomes derived exclusively from wages and salaries if the gross income did not exceed $3,000.

Consequently, the number of individual income-tax payers was increased by almost 11 million or by over 41 per cent in this one year. For 1942, over 36 million individuals, or about two-thirds of those gainfully employed, reported taxable incomes, of whom about 16 million people, or approximately 44 per cent of all individuals reporting, used the short, simplified form. Of the remaining 20 million individuals, *i.e.*, those who used the larger form, another 16 million people, representing likewise another 44 per cent of all individuals reporting, stated various incomes under $3,000. Combining these two groups of individuals reporting small incomes on different forms, there were about 32 million individuals, repre-

senting almost nine-tenths of all individuals reporting incomes for 1942, who reported incomes under $3,000. Nevertheless, their combined incomes constituted only two-thirds of all individual incomes reported for that year. This lack of proportionality, although less than in the previous years studied, indicates that considerable economic inequality still existed.

In 1942, individuals receiving incomes under $5,000 made up 97 per cent of all those reporting income; they received 82 per cent of all individual income reported. It will be remembered that for 1935 individuals reporting incomes under $5,000 had made up 90 per cent of all individuals reporting income and had received only 60 per cent of all individual income reported. Going still further back, the group of individuals receiving under $5,000 in 1928 had made up 75 per cent of all individuals reporting income and had received only 33 per cent of all individual income reported. This review would seem to indicate considerable decrease in economic inequality. The relative size of the group receiving incomes under $5,000 had increased moderately, but its relative share of the total income received and reported had increased markedly.

On the other hand, individuals receiving over $5,000 in 1942 made up only 3 per cent of all those reporting incomes for that year, but they received 18 per cent, or six times their numerical proportion, of the total individual incomes for that year. For 1935, individuals receiving over $5,000 had made up about 10 per cent of all those reporting incomes, but they had received 40 per cent, only four times their numerical proportion, of the total individual incomes for that year. Finally, for 1928, the group of individuals receiving over $5,000 had made up 25 per cent of all individuals reporting incomes, but they had received about 67 per cent, less than three times their numerical proportion, of the total individual incomes for that year. Again it must be observed that the ratio of large-income receivers to all income receivers had declined more rapidly than the ratio of their income to total income. The proportion of large-income receivers and even their relative share of the total income had decreased notably and steadily, but the disproportionality of income to individuals had increased from 1928 through 1935 to 1942. It would seem that further concentration of income among a relatively smaller group of rich people receiving a relatively smaller share of total income had taken place, despite a broad, general reduction of economic inequality throughout American society as a whole.

In 1942, there were 38 individuals reporting annual incomes over 1 million dollars, instead of 41 such persons in 1935, and 511 such in 1928; there were 224 individuals, instead of 150 and 1,500 persons, respectively, reporting incomes in excess of $500,000; and there were roughly 6,000 individuals, instead of 2,600 and 16,000 persons, respectively, reporting incomes of $100,000 or more. Evidently there were more large incomes in

1942 than in 1935, although far less than in 1928. This observation is not surprising, because the year 1935 was less prosperous than either 1928 or 1942. A comparison of the situation in 1942 with that in 1928 would be more fair, more striking, and more significant than a comparison of 1935 with either 1928 or 1942. It is true that the war prosperity of 1942 did create or revive some large fortunes, but they were, relatively at least, fewer and smaller in 1942 than in 1928; the national income in 1942, as shown in the preceding chapter, was far greater than in 1928.

In 1942, 385,000 individuals, a substantial group, but only slightly over 1 per cent of all income receivers, reported incomes in excess of $10,000;

TABLE 20. INDIVIDUAL INCOME TAXES FOR 1942

Groups	Number of individuals	Percentage of individuals	Total amount of income, millions	Percentage of income
Form 1040A	16,106,039	44.18	$25,716	32.72
Form 1040				
Under $1,000	3,189,377	8.75	2,102	2.68
$1,000– $2,000	7,156,597	19.63	10,846	13.80
$2,000– $3,000	5,423,622	14.88	13,277	16.89
$3,000– $5,000	3,415,383	9.37	12,426	15.81
$5,000– $10,000	779,448	2.13	5,210	6.63
$10,000- $25,000	296,217	0.81	4,393	5.59
$25,000– $50,000	63,975	0.18	2,162	2.75
$50,000– $100,000	19,416	0.05	1,299	1.66
$100,000– $150,000	3,484	0.01	419	0.53
$150,000– $300,000	1,931	.....	383	0.49
$300,000– $500,000	397	.....	150	0.19
$500,000–$1,000,000	186	.....	124	0.16
Over $1,000,000	38	.....	81	0.10

they received over 10 per cent of all individual incomes for that year, or about ten times their numerical ratio. In the same year, 1942, about 1 million individuals, or a little over 3 per cent of all income receivers, reported incomes in excess of $5,000; nevertheless, they received almost 18 per cent of all individual income reported, or six times their numerical ratio. Economic inequality had been reduced, but it had not been eliminated. Its persistence is attested by the continuance of considerable disproportionality of income, particularly before the payment of heavy, progressive taxes on large personal incomes.

It must be emphasized, however, that these figures are those of individual incomes before the payment of Federal and state taxes. The effect of steep

surtax rates, running over 80 per cent on the largest personal incomes, still further reduced economic inequality. Huge war profits were largely absorbed by excess-profits taxes and by heavy income taxes on business concerns with the additional right of renegotiation of contracts by the Federal government. There was double as well as progressive taxation, because individuals paid income taxes on dividends from corporations that had already paid corporate income taxes.

Table 20 gives a summary of individual income-tax returns for 1942. It contains the incomes reported, but neither taxes paid nor incomes left after payment of taxes.

28–4. Geographical Maldistribution of Income. Economic inequality is expressed not only in wide differences of purchasing power among individuals within a particular nation, but also by glaring discrepancies between the total or per capita incomes of various nations and those of different areas within a particular nation.

a. Among Various Nations. The United States is the richest and most productive country in the world. This was true before the Second World War; and the contrast is even greater now, because our land was spared much of the devastation that Europe suffered. The per capita national income of the United States was estimated at $508 for 1936. Next in that same year came Great Britain with a per capita national income of $457; in about that same category were other self-governing members of the British Commonwealth of Nations, such as Canada, Australia, and the Union of South Africa. In 1936, Germany was third with a per capita national income of $389, and France was fourth with a per capita national income of $276; a decade earlier in the period immediately following the First World War, their respective positions had been reversed. Then came the lesser nations of Europe, such as Italy, Spain, and the Danubean states. In last position were those Asiatic countries for which there were available comparable statistics; for example, the per capita income of Japan was only $54 in 1936. Adequate information was lacking for the Union of Soviet Socialist Republics of Russia. The final outcome of the Second World War was foreshadowed by this prewar comparison [1] of the per capita national incomes of the nations concerned.

b. Within the United States. The greatest concentration of our national wealth has been in the older New England and Middle Atlantic states, with the East North Central division taking third place. These three areas are heavily populated, but per capita income as well as gross income has been high therein. The Pacific Coast is also a rich area, more so per capita than *in toto*, because it is less densely settled. On the other hand, one of the poorest regions of the United States, judged either by gross income or by per capita income, is the South, but this economic discrepancy

[1] National Industrial Conference Board, *Economic Record*, Aug. 3, 1939, p. 35.

is not so great now as it was in the decades following the Civil War. Industries are developing there, and a complete dependence on agriculture, which is ordinarily a poor occupation, is no longer the case.

The per capita income of Americans reached a new peak of $1,264 in 1947, which was more than double that of the $575 income in current dollars for every man, woman, and child in the United States in 1940; it was 18 per cent greater than that for the previous year, 1946.[1] The total national income paid to individuals in 1947, including wages, dividends, interest, rents, and social security benefits, was estimated at 197 billion dollars. Agricultural areas were unusually well off then, because of the prevailing high prices for farm products. Nevada in 1946 had the highest per capita (not total) income, namely, $1,703. New York came second with $1,633. Then followed the District of Columbia with $1,569 and California with $1,531. Close rivals for next position were New Jersey with $1,494, Delaware with $1,493, Illinois with $1,486 and Connecticut with $1,465. At the other end of the scale were fifteen of our Southern states; Mississippi came last with a per capita national income of only $555 for 1946. Glaring geographical maldistribution of purchasing power is evidenced by the fact that the per capita income of the richest states in this nation has been about three times that of the poorest states. The result is a great discrepancy in the educational opportunities and health services available to American citizens in various sections of the country.

These statistics give a factual basis for our discussions of Federal subsidies to individual states for old-age assistance, community health and housing, public education, and so forth. Federal grants or loans for such purposes are designed to provide greater equality of opportunity to people in low-income areas and low-income groups. They constitute an extension of the movement from the benefit-received theory of taxation to the ability-to-pay theory of taxation for general social welfare.

28–5. Occupational Distribution of Our National Income. The United States Bureau of Foreign and Domestic Commerce has apportioned the national income among our leading occupations. This occupational distribution has a direct relationship to the geographical distribution just outlined. Of special importance are the four basic occupations of agriculture, manufacture, trade, and service. Table 21 gives their relative percentages of the total national income for several different years, including those of prosperity, depression, and recovery. The period of the Second World War was one of unusual activity and occupational distortion; consequently, it is omitted here. Contrasts in the relative importance of these four basic occupations with swings of the business cycle are evident. Nevertheless, the great and growing importance of manufacture stands out in contrast to the long-run declining significance of agriculture in this country.

[1] U.S. Department of Commerce.

TABLE 21. PERCENTAGES OF NATIONAL INCOME PRODUCED BY PARTICULAR OCCUPATIONS *

(In percentages of total)

Occupation	1929	1932	1934	1940	1941
Agriculture	8.8	5.9	9.2	6.8	7.6
Manufacture	23.8	14.2	20.2	26.0	29.2
Trade	13.5	13.3	13.1	15.0	13.9
Service	11.4	13.6	11.9	9.6	8.5

* U. S. Bureau of Foreign and Domestic Commerce, Division of Economic Research.

Table 22 shows the distribution of the national income by major industrial sources in current dollars for several years before the Second World War.

TABLE 22. DISTRIBUTION OF NATIONAL INCOME BY OCCUPATIONS *

(In billions of current dollars)

Occupation	1929	1940	1941
Agriculture	6.8	5.3	7.4
Mining	1.9	1.7	2.1
Manufacturing	20.9	20.1	27.6
Contract construction	3.6	2.5	3.7
Transportation	7.0	5.4	6.4
Power and gas	1.4	1.5	1.6
Communications	1.0	1.0	1.0
Trade	11.9	11.6	13.2
Finance	10.1	7.0	7.5
Government	6.4	10.2	11.7
Service	8.3	7.4	8.0
Miscellaneous	4.0	3.5	4.3
Total	83.3	77.2	94.5

* U. S. Bureau of Foreign and Domestic Commerce, Division of Economic Research.

The growing importance of government as business and government in business, as well as the increasing significance of governmental control over business, was evident even before the Second World War. Government's share of the national income produced rose from 6.4 billion dollars

in 1929 to 11.7 billion dollars in 1941; these were years of public work and relief during the depression before our participation in war. Expressing this development in percentages instead of dollars (not shown in table), government's share of the national income produced rose from 8.4 per cent in 1929, to 17.3 per cent in 1934 (a year of attempted recovery through public works projects and relief programs), to 13.2 per cent in 1940, and to 12.4 per cent in 1941. The preceding chapter indicated how the government's share of our greatly increased national income rose disproportionately during the years of our participation in the Second World War.

28–6. Functional Distribution of Income among Factors in Production. Economists outline the following four factors of production, namely, land, labor, capital, and business enterprise. Shares in distribution going to

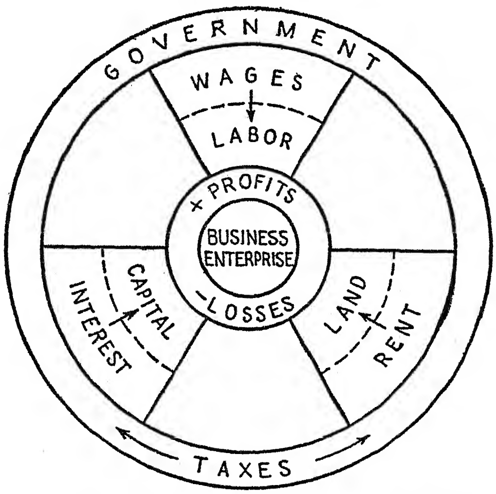

CHART 14. Factors in production and corresponding shares in distribution.

these four factors of production are, respectively, rent, wages, interest, and profits or losses. Distribution is a pricing process as well as a sharing process; it gives value, as well as products, to each of these factors of production. Again, a share in distribution is also a cost of further production. Wages, for example, are rewards for labor performed; but they are also constituent elements in the cost of producing a good, which are included in its price. Like the value of a commodity or service, the rate of return on a factor of production is determined by its relative demand and supply forces. It is expressed by its price in the open market, *e.g.*, the current interest rate or the prevailing wage rate for a particular type of labor.

Chart 14 pictures these factors of production and their corresponding shares in distribution. It includes also government as a factor and taxes as its share.

In a new country, rents are low because the supply of land is abundant as compared with that of labor and capital. In an older and more densely populated country, rent absorbs a greater portion of the national income. In any given time and place, the rent that a piece of land yields its owner is conditioned by the relative scarcity, desirability of location, and degree of fertility of that type of land. Such a statement may be a partial explanation of rent, but it does not justify it, for it assumes the existence of private-property rights in land.

The indirect or roundabout method of production is first to create capital and then to produce consumption goods with the aid of this capital. The Industrial Revolution increased the roundaboutness of production and intensified the importance of capital. The supply of capital depends, on the one hand, on the rate of productivity and, on the other hand, on the degree of thrift and saving. A choice must be made between present and future goods, and this choice is reflected each year in the ratio between capital goods and consumption goods in the national income. An individual may spend his income or he may invest it, directly or indirectly, in some productive enterprise. The interest rate depends on the relative demand for and supply of capital. The justification of interest payment, however, again assumes the individual ownership and saving of capital.

Profits represent an uncertain and residual share in the process of distribution. They arise from a multiplicity of causes, such as changes in prices and fluctuations in demand. They originate in the present system of individual enterprise and in the dynamic character of modern economic life. The justification of profits lies in the assumption of business responsibilities and financial risks of production by individual enterprisers and captains of industry.

Taxes, or the portion of the national income that goes to government, may be regarded as a fifth share in distribution; it is public or collective, not private or individual, income. Finally there is the replacement fund of industry, which is not really a share in distribution.

28-7. Earned and Unearned Income. Attempts have been made to classify these shares in distribution as earned or unearned incomes. Wages are generally the result of labor and human effort. Hence they are commonly regarded as earned incomes. Inasmuch as land is a free gift of nature, rent has been attacked as an unearned income. In profits there seem to be both earned and unearned elements. Monopoly profits are antisocial and constitute an unearned element, but competitive profits in production are rewards for economy and efficiency.

If capital is the result of saving, interest may be justified as earned income by those individuals who do the saving. Critics of the present economic system, however, argue that such is frequently not the case. Individuals who have inherited large fortunes may live luxuriously on the

interest from their investments and practice very little abstinence. On the other hand, low-wage groups practice great abstinence, but receive little or no interest.

Although some large fortunes originated from fortuitous circumstances and even unsocial practices, the founding of many small property incomes required labor and abstinence. Some individuals worked hard and saved rigorously in order to accumulate the capital represented by stocks and bonds. Should society limit the right to enjoy the result of past labor and abstinence and should it interfere with the right to bequeath this accumulated capital to its owners' children? Another individual may have invested his wages in land, the private ownership of which society has condoned, and even protected, for centuries. Should this income from land be called unearned, and should the government attempt to appropriate this rent or any portion of it?

Such questions bring us face to face with the entire theory of distribution and with comprehensive programs of taxation, including inheritance taxes, progressive income taxes, excess-profits taxes, and the social absorption of the unearned increment from rising land values. Our present aim is merely to review the distinction between property and service incomes and to indicate some practical difficulties involved therein.

Although a sharp distinction between earned and unearned income is difficult to carry out in a system of taxation, a rough separation of property and service shares is common. Again, the theory of ability to pay, carried out by the principle of progression, is now generally accepted in public finance; it taxes property more heavily than service shares. Finally, some unearned increments, chiefly inherited property, are being taxed more heavily and more generally than earned incomes. These problems were discussed in Part Five, on public finance.

28–8. Division of National Income between Property and Service Shares. We have seen that the share of the national income going to property was unequally distributed and that a relatively large portion of it was concentrated in a few hands. Now we are ready to ask how large is the property share as a whole, *i.e.*, what percentage of the total national income do rent, interest, and dividends combined absorb. Has there been functional, as well as personal, inequality?

Dr. King [1] made an analysis of the four shares in the national income from 1850 to 1910. A combination of rent, interest, and profits shares represents a rough approximation of the total property income. During these 60 years property absorbed about half the national income, varying from 60 per cent in the decade from 1850 to 1860 to 50 per cent in the next decade, which was featured by the inflation of the Civil War, to 45 per cent

[1] King, W. I., "Wealth and Income of the People of the United States," The Macmillan Company, New York, 1923.

in the two decades from 1870 to 1890, the low point of the study, rising again in the next decade to about 55 per cent, but falling again to 50 per cent in 1910. As the service share is the total income less the property shares, its trends during this period were just the reverse of those of property. The service share gained substantially from 1860 to 1870 and modestly from 1870 to 1890; it lost slightly from 1890 to 1900 and gained relatively from 1900 to 1910.

A more recent study by Dr. King [1] of the division of the national income between property and service shares by years, from 1914 to 1928, brings this story down to the great depression. Apparently, the fairly even division for the period from 1850 to 1910 continued until the period of wartime inflation, during which the property share lost and the service share gained by 5 to 10 per cent; after which another period of stability ensued until the stock-market crash of 1929.

Looking backward from 1928 to 1850, it would appear that the national income was divided fairly evenly (not necessarily equitably) between total property shares and total service shares. Moreover, this division was fairly constant, *i.e.*, subject to relatively few and slight changes. If these studies permit any generalization beyond those simple observations, it is that total property income grew absolutely but declined relatively, and that total service income increased both absolutely and relatively.

28–9. Labor's Burden Compared with That of Property during the Great Depression. A study by Dr. Kuznets,[2] also working under the auspices of the National Bureau of Economic Research, analyzes the national income from 1929 to 1932 by types of payment. It gives the shares of the national income paid out, both in current dollars and in percentages of 1929 payments. The division is threefold and sixfold into (1) total labor income, including (*a*) wages and (*b*) salaries; (2) total property income, including (*a*) dividends and (*b*) interest; and (3) total entrepreneurial income, including (*a*) net rents and royalties and (*b*) entrepreneurial withdrawals, which roughly correspond to individuals' profits.

Significant differences are apparent in the trends of these various shares between 1929 and 1932. Whereas total labor income declined by 40 per cent and total entrepreneurial income by 45 per cent (the greatest decrease in all three totals), total property income declined by only 30 per cent. Again, this decline in property income was delayed for a full year later than that in the other two shares.

When total labor income is broken down, it appears that salaries in selected industries declined by 40 per cent, but that wages in the same

[1] King, W. I., and Lillian Epstein, "The National Income and Its Purchasing Power," The National Bureau of Economic Research New York, 1930.

[2] Kuznets, Simon, "The National Income, 1929–1932," Bureau of National Economic Research, *Bulletin* 49, June, 1934.

selected industries decreased by 60 per cent. This decline in wages was greater even than that in total entrepreneurial income, and far greater than that in total property income. In other words, wages suffered more than any other share. Salaries, however, held up fairly well during 1930, and in 1931–1932 they declined less than any other share except interest.

When total property shares are broken down into interest and dividend payments, some striking contrasts come to light. Although dividend pay-

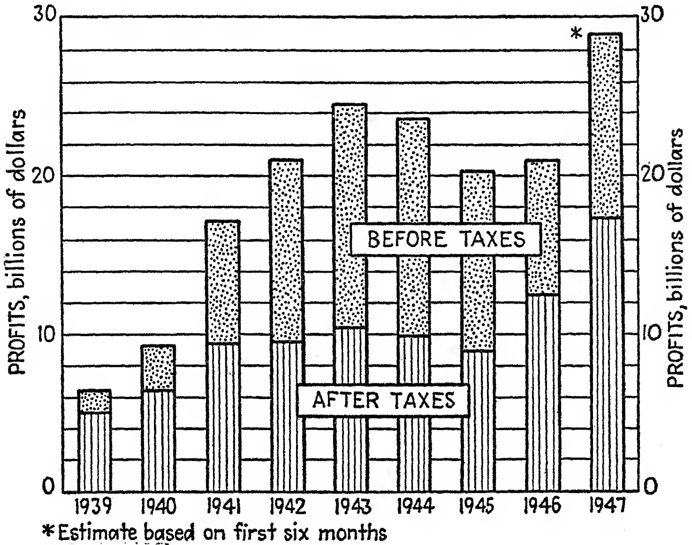

CHART 15. Profits during the Second World War. (*Data from the President's Midyear Economic Report to Congress, 1947. Adapted from The New York Times, Sunday, July 27,* 1947.)

ments declined by over half from 1929 to 1932, the decrease in interest payments was almost negligible. Again, this decline did not take place until after 1930, for which year dividend payments were only slightly lower than in 1929 and interest payments actually greater.

This analysis of the distribution of the national income during the depression years from 1929 to 1932 demonstrates that labor shares, including wages and salaries, suffered more than did property shares, including dividends and interest, although entrepreneurial shares as a whole suffered more than either service shares as a whole or property shares as a whole. As the national income declined, labor's share decreased relatively as well as absolutely. On the other hand, the fraction of the dwindling national income going to property was greater in 1932 than in 1929. Within the labor group, wages suffered more than did salaries or even entrepreneurial income. Chart 15, above, shows later course of profits.

It seems fair to conclude then that the great depression not only lowered general levels of economic well-being, but pressed down especially hard on

those least able to bear the burden. Economic inequality, we have seen, existed before the great depression. It is now apparent that it persisted during the depression. Economic inequality was reduced later by progressive taxes and by increased earnings during the war.

28–10. Persistence of Economic Inequality. Economic inequality may be regarded as natural in ancient societies, which are characterized by caste systems and the institutions of slavery or serfdom. But the change from status, *i.e.*, a condition fixed by birth, to freedom of contract did not eliminate economic inequalities. Indeed, the development of modern capitalism and industrialism created new fortunes from commerce and manufacture.

American millionaires and captains of industry dominated our pecuniary civilization as did barons and landlords their agrarian societies. Hence it has been contended that ancient aristocracy was merely replaced by modern oligarchy or plutocracy, a military feudalism by a financial feudalism, and absentee landlordism by absentee capitalism.

The economic development of new countries was characterized by dollar diplomacy and by the creation of huge fortunes from the ruthless exploitation of their natural resources, such as timber, coal, and oil. Later industrialization was accompanied, likewise, by the emergence of railroad magnates, packing princes, beer barons, and match kings.

The exploitation of the United States under a system of individual enterprise and a philosophy of *laissez faire* was rapid but wasteful of natural and human resources. It converted a virgin continent into an industrial empire, but all the children of all the people did not share equally in their rich natural legacy. Our analyses of the ownership of the national wealth and of the distribution of the national income of the United States disclosed the fact that economic inequalities continued in this country through periods both of national prosperity and of depression.

28–11. Forces Making for Continued or Increased Economic Inequality. The capable student can discover for himself numerous specific causes of economic inequality and of the concentration of wealth in huge private fortunes. Among them would appear large governmental subsidies formerly granted to certain railroads and the capitalization by some public-service corporations of exclusive franchise rights previously given them. It should be remembered, however, that railroads and other public utilities were at first regarded as highly speculative ventures. New industries, if successful, are the sources of great profits and large fortunes. The establishment of the railroads and other utilities may be paralleled today by the more recent development of the airplane, automobile, telephone, radio, and motion-picture industries. Perhaps our dynamic and individualistic economy requires the incentive of large and immediate profits to attract capital and enterprise into new and risky undertakings.

Another source of great fortunes lay in our rapidly increasing land values, particularly in growing cities. The essential elements of success here have been sagacity and patience, rather than inventive genius or arduous productive effort. Witness the early purchase and the long-continued holding of land on and about Manhattan Island by John Jacob Astor and his descendants.

Wars have been another source of private profit and economic inequality. Fortunes have been made from the possession or acquisition of those commodities essential for military and civil consumption. Again, wars have been featured by monetary inflation. Rising prices invited profiteering by the few, while the great majority suffered from high costs of living. Hence, rationing of essentials and price control were invoked during the Second World War.

Speculation in commodity markets or stock exchanges has created large fortunes for a few successful individuals who were shrewd or fortunate. Sometimes they resulted from such unsocial practices as cornering the market or manipulating prices. Huge profits have been made by financial promotion, often of sound enterprises in which control was concentrated in the hands of a few insiders, but sometimes by underwriting questionable ventures that were unloaded on a gullible public. The United States has not permitted a national lottery, but Wall Street was a fairly acceptable substitute. A few high prizes were drawn occasionally; they diverted attention from the numerous blanks. The crash of 1929 terminated a decade of rising security prices and stock speculation; it also led to the establishment of Federal control through the creation of the Securities and Exchange Commission, explained in Chaps. III and IV.

Industrial combinations and monopolies have increased economic inequality; they have rewarded sagacity rather than service. Sometimes they have resulted from the economic benefits of large-scale production under a managerial genius, but more often they have stemmed from the financial strategy of unfair competition. The development of the trusts in the closing decades of the past century and the opening years of the present century, as explained in the preceding part of the text, created huge fortunes in oil, steel, tobacco, aluminum, and other commodities. Trusteeship has permitted the transfer of active control with perpetuation of financial interest. It has made for further concentration in industry; it has strengthened the grip of the "dead hand" and lengthened the reach of "absentee capitalism."

28–12. Forces Reducing Economic Inequality. A list of forces opposing economic inequality would comprise all those influences which tend to restrict or to negate the causes of concentration in the ownership of wealth just cited. Among them would be more effective regulation of large corporations, industrial combinations, and public utilities; better supervision

of security issues and trading in them; the elimination of wars, inflation, and the dizzy dance of the dollar; the social absorption of the unearned increment from socially created or fortuitously increased land values; and the public conservation of natural resources.

The development of property as a social trust, of profit sharing and labor copartnership, of increased cooperation, of more effective collective bargaining, and of all institutions and practices on behalf of the economically weaker elements in the community lessen economic inequality and the concentration of wealth. The extension of social-insurance schemes from workmen's compensation to include old-age pensions, and sickness and unemployment insurance have cushioned industrial insecurity and lessened economic inequality. Again, the reduction of child labor and the increase of educational opportunity for all young persons in accordance with their abilities and needs have made for greater democracy and social progress.

Taxation programs play an important part in the reduction of economic inequality. The principle of progression is applied to swollen incomes and large estates. The payment of progressive death duties on huge fortunes tends to dissipate them after several generations.

Any such list of forces is neither final nor complete. The student should use it merely as a point of departure for his own thinking.

28–13. Effects of Economic Inequality. There are many reasons why gross inequality of income is undesirable. They may be classified arbitrarily but conveniently as economic, social, political, and philosophical arguments; this order will be followed in the present discussion.

a. Economic Aspects. Production is influenced by effective demand rather than by potential desire. Economic demand may be defined as a desire that is accompanied by sufficient purchasing power to make itself felt. Only if incomes were evenly distributed throughout society could it truthfully be said that production is determined by the wants of all consumers. Glaring economic inequalities make it profitable for producers to satisfy the slightest whim of the wealthy and to ignore the pressing needs of the poor. Thus the quantitative distribution of the national income determines the qualitative character of production.

Demand, rather than desire, determines not only the character of production but also the channels of exchange. Thus, during a recent famine in China, that country exported eggs to America. The need for food was greater in China, but the effective economic demand was greater in the United States. Similarly, generations ago famine-stricken Ireland exported grain to more prosperous England, in response to market demand rather than social needs.

Many individuals who are not socialists accept the economic ideal of the production of necessities for all before luxuries for a few. Although this ideal requires the reduction of economic inequality, it does not necessitate

complete economic equality or the collective ownership of the instruments of production. It is socialistic, but it is not socialism.

The demand for necessities is relatively stable. It can be anticipated with a smaller margin of error than can the demand for luxuries. Hence this change in the character of our national real income would lessen some of the wastes of our present individualistic economy. Economic inequality is charged not only with misdirection of production, but also with overinvestment and underconsumption. Hence it is viewed as an important causal factor in industrial depressions and the wide swings of the business cycle. The wasteful operation of the principle of diminishing utility is mitigated to some extent by the great variety of economic goods that we now enjoy. When the utility of more clothes or another automobile becomes small, the wealthy individual can spend his income in other ways. On the other hand, the dollar of the poor man will be spent for a larger proportion of necessaries than the dollar of the rich man, whose most pressing needs have already been met. Hence the more equitable distribution of purchasing power would result in an increase in consumption utilities.

b. Other Effects of Economic Inequality. Great differences in income are productive of social instability as well as economic waste. Inadequate wages result in subnormal planes of living for some people, while other individuals are indulging in luxurious leisure. Poverty and riches, existing side by side, incite social unrest. The palaces at Versailles were erected by peasants who lived in huts. In modern American communities spacious country clubs and crowded slum tenements are both to be found.

Economic inequality makes for social stratification and the formation of noncompeting economic groups. Status is a condition fixed by birth, as compared with freedom of contract. Although neither slavery, nor a caste system, nor inherited titles exist in modern America, the perpetuation of large fortunes and the persistence of poverty have set off the classes from the masses as a practical reality, in spite of our liberal idealogy. For many individuals in the great masses of our population equality of opportunity is a far-distant ideal.

Extremes of economic inequality have serious political effects. Large fortunes may corrupt governmental officials, or at least exert undue influence on them. Open or secret miscarriage of justice may be the result. The flagrantly unequal distribution of a great national income may convert a democracy into a plutocracy. Such was the history of the later Roman Republic.

> Ill fares the land, to hastening ills a prey,
> Where wealth accumulates and men decay.

Finally, there are philosophical objections to great inequality of income. On the basis of abstract justice, why should one individual receive an

enormous income and another a pitifully small one? Let us assume that both are economic producers and that each contributes to the national income according to his individual ability and opportunity. Neither one's environment nor one's heredity is of one's own making. Prince and peasant have merely been dropped into different social surroundings. The fact that one individual is born with an excellent physical constitution or with exceptional mental ability, whereas another individual is born with some physical defect or with feeble-mindedness, is no merit or fault of his own. The same observation can be made concerning different social heredities and different social positions into which people are born.

Communists have adopted the slogan, "From each according to his ability and to each according to his needs." Such a simple analysis of production and distribution sets forth a noble ideal, but it is beset with practical difficulties and serious objections. If one's income depends on the size of one's family, there is greater incentive to the biological reproduction of children than to the economic production of goods.[1] Such questions take us back again to the fundamental issue of distribution. Should people be rewarded according to breed, greed, need, or deed?

28–14. Conspicuous Consumption. The manner of consumption of one's income is as significant as its size and source. Some large fortunes have been squandered while others have been saved. Some have been put to good use, while others have not.

Sometimes the luxury and leisure indulged in by the so-called "social set" are as socially undesirable as they are economically unproductive. The central purpose may be the display of wealth and idleness with the consequent inference of superiority. Economic success, demonstrated by ostentatious consumption, expresses the same human desire for self-glorification formerly satisfied by military success on the field of battle.

This situation has been termed[2] the "conspicuous consumption of the leisure class." The possession of a given commodity or the consumption of a certain service may be indulged in not because of its utility to the consumer but because of the social prestige that accompanies its display. Thus an individual may like to walk or to drive his own small automobile; nevertheless, the possession of a limousine and the employment of a liveried chauffeur indicate prosperity, which, in turn, calls for respect. Going to the opera may gratify no love of music, but it does afford an opportunity to wear expensive clothing and jewelry. In this manner the tired but successful businessman may be considered one of the social elite; he has arrived, figuratively as well as literally. Perhaps he also expresses conspicuous consumption through his wife's gowns and jewels.

[1] Professor Carver points out the danger of this "spawning" process in his "Essays in Social Justice."

[2] VEBLEN, T., "Theory of the Leisure Class," The Viking Press, Inc., New York, 1935

28–15. Private Fortunes as Public Trusts. Andrew Carnegie exemplified the ideal of great fortunes as public trusts,[1] in contrast to their opportunity for conspicuous consumption. His own life was simple and his tastes were frugal. He returned to society a large portion of his income in the form of free libraries. John D. Rockefeller likewise donated millions to educational work and to medical research. Julius Rosenwald, Samuel Fels, and Edward Filene are additional examples of socially minded philanthropists.

Private fortunes as public trusts constitute collective consumption on private initiative. It is difficult to overemphasize the social usefulness of such wise donations. Society might not have done these things of its own accord. This ideal is as constructive in character as conspicuous consumption is negative. It is an argument for capitalism instead of an indictment of it.

Such a policy, however, has been criticized as undemocratic in spite of its generous motive and wise purpose. As it represents private philanthropy rather than public expenditure, it has been stigmatized as benevolent despotism or capitalistic feudalism. Such civic donations divert attention from the unsocial origins of some large fortunes in monopoly profits. All consumers have paid the bills in the purchases of these products, but they have not been permitted to say how the profits should be spent. Such have been the criticisms of rich men's philanthropies and the indictment of large fortunes as public trusts.

28–16. Survival of the Fittest—A False Analogy. It is sometimes assumed that economic competition affords an analogy with the biological struggle for existence. It is further asserted that the force of natural selection results in the survival of the fittest in business and the elimination of the unfit, or, rather, their relegation to the poverty group. Such an analogy is incorrect and misleading.

In the first place, "survival of the fittest" is meaningless outside its proper context, because the fittest are merely those most in harmony with their particular environments. The fittest are not necessarily the best, *e.g.*, a frog rather than a horse in a marshy environment, a sinner rather than a saint in competition with unscrupulous rivals.

In the second place, the biological struggle for existence is physical, and each individual or species tends to survive or perish according to the presence or absence of favorable traits. But social evolution has produced customs and laws that may be meritorious but that interfere with the operation of the principle of natural selection. Inheritance laws and the institution of private property place barriers between many individuals and a ruthless struggle for existence. Some persons may be supported in

[1] Carnegie, A., "Gospel of Wealth," D. Appleton-Century Company, Inc., New York, 1900.

luxury and leisure without the effort and even the need for earning their own living. On the other hand, other individuals enter the economic struggle with handicaps such as the burden of poverty and consequent lack of opportunity. The economic struggle is neither natural nor fair.

28–17. Predatory and Neutral Activities. Assumption of superiority on the part of a successful businessman is not always justifiable, because of the existence of numerous fortuitous circumstances. Such a businessman may have been fortunate rather than sagacious. Again, individual ability should not be evaluated apart from social purpose. Mere cleverness of itself is not sufficient to achieve or to warrant success. It must be exerted in a productive fashion. Although economic society is competitive, the skill of a pickpocket or the strength of a highwayman is not rewarded but punished. Society has set up certain rules of the game; it has attempted to eliminate some of the most predatory methods of achieving success, even in a highly competitive economy.

There are still many neutral or socially undesirable ways of securing private profits. It is difficult in a dynamic society for the forces of social control to keep abreast of changing conditions and to express themselves immediately and adequately. It takes time to arouse public opinion and to crystallize it into effective legislation. In the meantime, clever individuals may create fortunes in economically unproductive and socially undesirable ways. Illustrations are monopoly profits, gambling on the stock exchange, and speculation in real-estate values. Economic success does not always indicate or measure economic productivity along socially desirable lines.

28–18. Acquisition According to Production. This slogan cannot be dismissed as a mere socialistic concept. It is an economic ideal far older than socialism. There is Biblical authority for the assertion that men should earn bread by the sweat of their brows, and for the indictment of those who reap where they have not sown. Indeed, acquisition according to production may be regarded as an American ideal, which can be attributed to Captain John Smith of the Virginia colony, who is alleged to have said that only those gentlemen who worked should eat.

In every primitive community there is little bread of idleness for a leisure class practicing either vagrancy or conspicuous consumption. But with the transition from a deficit economy of pain to a surplus economy of pleasure, a leisure class develops. The transition from a simple and personal economy to a complex and impersonal one has changed and enlarged the age-old problem of distributive justice.

It is easy to say glibly "acquisition according to production," or "he profits most who serves best"; but to determine or to measure economic productivity is difficult. Types and degrees of social desirability are still

harder to fashion and to fathom. What limits, if any, should be set to a man's ability to acquire wealth?

It is impossible to measure the productive contribution of the discoverer of anesthetics for surgical operations or of the inventor of the steam engine, the telephone, or the radio. One would hesitate to set any limits to the rewards of such scientists and inventors. Indeed, these individuals have rarely received compensation commensurate with their social or economic contributions. The great fortunes created by such discoveries and inventions have often gone to financial promoters rather than to the inventive geniuses themselves. On the other hand, as has been indicated, numerous fortunes have been created in uneconomic or unsocial ways.

In attempting an answer to the old question, "How much is a man worth?" we should insist merely that his individual acquisition be determined by his economic production or by the social desirability of his services. Such a statement is not an answer; it merely rephrases the question. It does not give a measure of production or a valid test of social service.

28–19. Equality of Opportunity. Equality of opportunity does not imply an absolute equality but rather a conscious inequality based on biological differences. Although it assumes equality before the law, such an ideal would permit each individual in society to develop to the limits of his inherent ability, and to assume either a position of responsibility or a more humble occupation, according to his natural gifts, acquired training, and demonstrated accomplishments.

Equality of opportunity would minimize artificial inequalities, which are the results of varying social heredities and which reflect fortunate or unfortunate economic environments more than different native abilities. Every individual would be forced to start the race of life without competitive social advantages and without acquired handicaps. Unless individual initiative is to be killed, all participants should be permitted to progress at varying rates, according to the inherent powers with which nature has so differently endowed people and according to the varying degrees to which they have been utilized in economically productive and socially desirable ways.

A flat equality, which certain writers falsely interpret as democracy, would cause injustice. But injustice results now when positions of responsibility and high salary are filled by mediocre individuals, when men of superior ability are forced to remain in the lower economic groups because of a lack of education or of industrial opportunity. Gray's famous "Elegy in a Country Churchyard" contains intimations of existing inequality of opportunity in its references to a "mute, inglorious Milton" and a "Cromwell guiltless of his country's blood." Its beautiful lines have been frequently quoted, but its social and economic connotations have been blissfully ignored.

28–20. Competition in a Democracy. A truly democratic society must be selective. It should maintain a differentiated educational system in which the type of education given each student depends on his ability and interest, not on the income of his parents. As admission to the professions requires a long period of preparation, many promising children are now forced to leave school as soon as the law permits. Although a genius will triumph over all obstacles and rise out of blind-alley occupations, such widely advertised cases are relatively rare. Scant attention is paid to the more numerous instances of individuals of no conspicuous ability who are kept in school indefinitely by their wealthy parents and who are later placed in lucrative positions.

Equality of opportunity requires the removal of artificial obstacles, for it would compel all people in society to stand on their own feet. On the other hand, it would frankly recognize biological differences by permitting each individual to find his own level in a competitive economic society. Such a concept may be socialistic, but it is not socialism. It does not imply the collective ownership and operation of industry, and it does not involve the extinction of individual enterprise. But it does suggest the modification of property rights by progressive income and inheritance taxes.

Equality of opportunity recognizes the competitive character of modern economic society and even the importance of individual acquisition as a necessary economic stimulus. But it seeks to reward an individual's own achievements more than his selection of parents. It aims to correlate more closely individual acquisition with individual production.

Although the pecuniary interest is powerful, it is not the only strong incentive to creative activity. Socialists, for example, stress social esteem and popular recognition of public service. Patriots receive commendation for services that money could not buy, and saints sacrifice themselves for their fellows. Equality of opportunity, however, would not substitute the laurel wreath for the purse of gold. It merely seeks to make acquisition proportionate to production by reducing the gains of unscrupulous cleverness and the advantages of inheritance or fortuitous events.

Guide Questions on Text

1. *a.* What evidence have you of the unequal division of wealth in the United States?
   b. What indications are there of its reduction?
2. *a.* What evidence have you of the maldistribution of the national income?
   b. What indications are there of its reduction?
3. *a.* Distinguish between property and service incomes. Illustrate.
   b. Do you regard the expression "earned and unearned incomes" as fair or prejudicial? Why? Are they similar to the above?
4. *a.* Show how the national income has been divided between property and service shares.
   b. What tendencies, if any, have been evident? Why?

5. Show how the burden of the depression of the early thirties fell differently on various shares in distribution. Why?

6. Was there some decrease in economic inequality during the great depression? If so, suggest reasons.

7. Did the New Deal reduce economic inequality or merely attack it? Did it reduce incentive to initiative? Evidence?

8. Enumerate and illustrate various types of inequality. Which seem desirable and which undesirable? Which can be eradicated, which reduced, and which seem permanent? Why?

9. Distinguish carefully between equality, and equality of opportunity.

10. Is individual acquisition proportionate to economic productivity? Why or why not? Should it be? Give reasons for either position.

11. Outline and classify, if possible, causes of economic inequality.

12. Outline and classify, if possible, forces reducing it.

13. Indicate some important economic, social, and political effects of economic inequality.

14. Why is survival of the fittest a false analogy?

Topics for Investigation

1. Attempts to distinguish between earned and unearned incomes for purposes of taxation.
2. Veblen's concept of conspicuous consumption and the leisure class.
3. Private fortunes as public trusts.
4. Origin of some great fortunes.
5. Wars and profiteers.
6. Taxation of estates and inheritances.
7. Unearned increment from land.
8. Carver's concept of a scientific morality.
9. Marginal productivity theory of distribution.
10. Hobson's attempt at a human valuation for industry.

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See also Selected References, Chap. XXVII.

CHAPTER XXIX

THE BURDEN OF POVERTY OR ECONOMIC INSUFFICIENCY

29–1. Nature of Poverty and Pauperism. That group in society with the smallest income, and, consequently, with the lowest plane of living, is usually referred to as the "poor." The advance of civilization has increased economic prosperity and raised standards of living. The poor of today enjoy comforts and conveniences not possessed by peoples or princes of earlier societies.

Because poverty is a relative term, at any given time and place there are the comparatively rich and the comparatively poor. In spite of economic progress, the poor, in the sense of those in the lowest economic group, have persisted because of the continuation of economic inequality and the stratification of society into various economic groups. The poor, in this comparative sense, we shall have with us until or unless society should be modeled on some communistic plan. The elimination of the poor, in the sense of those in the *lowest* economic group, is as impossible as the elimination of the last train coach, which is frequently the victim in railroad wrecks.

The term "poverty" may be restricted to those individuals or families whose incomes are so small, and whose planes of living, consequently, are so low that neither health nor working efficiency can be maintained. Although standards of living also are relative, it is possible at a given time and place to formulate the elements and to estimate the costs of a minimum standard of decent living. Thus social pathologists regard poverty as a social disease and the poor as abnormal members of society. In this sense, poverty can be reduced, if not eliminated.

In contradistinction to the poor, paupers are those individuals in almshouses or those families in their own homes who receive assistance from the state or from charitable organizations. Pauperism is essentially a condition of dependency. Paupers belong to the social-debtor group, consisting of defectives, delinquents, and dependents.

Poverty and pauperism are not synonymous, and those individuals who live below the poverty line but who are too proud to ask for help should not be referred to as paupers. There is a strong tendency, however, for the poor to become paupers. Indeed, poverty has been compared to a narrow and treacherous footpath around the morass of pauperism; it is as easy to slip down from poverty to pauperism as it is difficult to emerge.

The proper treatment of paupers and other members of social-debtor groups belongs within the domain of sociology. But the economist, as well as the sociologist, must concern himself with problems of subnormal planes of living and inadequate wages. Objective causes of poverty, such as low wages and unemployment, which lie within the economic organization, are definitely within the field of applied economics.

29–2. Extent of Poverty and Pauperism. The extent of poverty is difficult to determine, for there are no absolute norms from which deviations can be measured. Nevertheless, it is apparent that poverty is a chronic, as well as an acute, problem of economic society. Although varying in intensity from time to time and from place to place, it never entirely disappears. Again, poverty displays itself in a more concentrated form in the cities than in the country, and in more aggravated needs in the winter months than in the summer.

Although the poverty rate may be smaller in rural sections than in cities, recent investigations make this doubtful. Urban poverty is conspicuous, but even more distressing conditions may be hidden away in obscure rural communities. For society at large, the expression "the submerged tenth" was formerly used to express the character and extent of poverty. With the advent of the New Deal, President Roosevelt substituted for it the phrase "a third of a nation" to refer to that portion of our population whose income was insufficient to maintain decent planes of living.

The new industrial revolution in the United States was lauded as the final conquest of poverty in this country. But our great national prosperity witnessed only a modest reduction in poverty, because increased industrial productivity was not accompanied by improved distribution and expanded social security. The great depression from 1929 to 1933 was marked by an unprecedented increase of poverty, pauperism, and relief work, public as well as private.

Such conclusions are dubious and such comparisons are dangerous, however, because standards of living and concepts of poverty are not constant but variable. What would be considered deplorable and inhuman today was regarded as unfortunate but natural by our grandparents. In earlier depressions people starved or froze to death, as they do today in primitive societies and war-stricken countries. Families in the lowest third of the nation referred to by President Roosevelt were existing in deplorable conditions in terms of current economic techniques of production and modern standards of living. Nevertheless, they were living better than the poor of other lands and earlier times.

The extent of pauperism is as difficult to determine as that of poverty. Many individuals and families receive various forms of assistance, of which no record is kept and to which little recognition is given. During the past

century, vast armies of dependents were cared for by outdoor relief, of which there was little accounting. Societies for the organization of charity attempted to bring order out of this chaos in the belief that one of the essentials of the scientific method is keeping complete and accurate records.

Indoor relief was formerly as haphazard as outdoor relief. Institutional records of admission and dismissal were poorly kept, if kept at all. Again, the almshouse frequently sheltered such divergent groups as dependent old folks and dependent children, the infirm as well as the shiftless. Recent United States censuses have placed the number of dependents in our various institutions at about the million mark, but the total number of paupers and semidependent individuals probably approximated several millions, even before the depression.

29-3. Social Attitudes toward Poverty. Almsgiving has been regarded as a religious duty and charity as a civic virtue. The old attitude toward poverty was similar to that toward war, namely, that it would always persist because it always had existed. A similar fatalistic attitude toward disease long prevented progress in the healing arts of medical science.

The modern attitude of science is that philanthropy is necessary for the alleviation of temporary distress, but that the elimination of poverty is the ultimate ideal. The same scientific spirit that has reduced the ravages of smallpox, yellow fever, and other physical diseases is now studying the social disease of poverty. It seeks the reduction, if not the elimination, of poverty through an intelligent and concentrated attack on its causes. Finally, social service, like health care, aims not merely at giving relief to all sufferers, but also at promoting decent or normal standards of living through the restoration of economic independence.

29-4. Causes of Poverty. *a. Single and Complex Causes.* Many students made the error of assuming that poverty had only one cause. Thus Malthus believed that poverty was due to the pressure of population on food supply. On the other hand, Karl Marx found its explanation in the ownership of the instruments of production by a capitalistic class and the resulting dependence of the proletariat on the bourgeoisie. Socialism therefore was his remedy. To Henry George, poverty was the result of individual rather than social absorption of economic rent and the unearned increment from land. In "Progress and Poverty," he pointed to the single tax and the elimination of the landlord as his answer to the problem of poverty.

There is no single cause of poverty, for this social disease is a complication of many elements. Moreover, some causes of poverty are also results. Although unemployment and low wages are important sources of poverty, numerous other factors exist. Moreover, such answers are inadequate, for the student is forced to seek further in his attempt to find those underlying causes of unemployment and low wages that contribute

to poverty. Our present purpose is not to select some one cause of poverty, or even to explain its several contributing causes, but merely to show the complexity of this problem and to indicate a possible method of analysis.

b. Individual and Social Causes. The familiar classification into personal and environmental causes is helpful, but it represents merely different ways of grouping similar causal factors and different avenues of approach toward the same problem. Sickness, for illustration, is both an individual and an environmental factor. Human sympathy engenders personal consideration for sick individuals, but scientific interest expresses itself in a study of the nature, causes, and significance of the disease itself. Again, individual causes of poverty indicate its incidence more than its causes, *i.e.*, what individuals will constitute that group, assuming a given amount of poverty. For an explanation of its existence, one must turn from the specific question why particular persons or families are poor to the more general problem of analyzing impersonal factors and objective causes in the environment that create that volume of poverty in society.

29–5. Objective Causes of Poverty in Our Economic Environment. By the use of efficient methods of production and improved economic organization, western civilizations have made a better adjustment to their environment than has the Orient, where dire poverty persists. Active adaptation and technological progress enable a dynamic society to keep ahead of the Malthusian specter of starvation. Thus, national prosperity is an underlying condition for the amelioration of poverty. It is determined both by our natural resources and by the arts of production. In both respects the United States has been fortunate.

Distribution, as well as production, is a vital issue in a causal analysis of poverty, which may exist along with so-called "national prosperity." Despite our tremendously increased productivity before 1929, as indicated in the preceding chapter, serious economic inequalities lingered. Insufficient income was a factor in economic inadequacy or poverty. The wages of many male workers were insufficient of themselves to support in comfort, or even in decency, a wife and several children.

Unemployment is another economic maladjustment that reduces still further the meager earnings of workers and brings many of them within the poverty and pauper groups. Seasonal employment and unemployment are featured by migratory labor, mushroom towns, and squatter communities. Economic depressions reduce employment and lower planes of living. Strikes have similar depressing and disturbing effects.

Changes in industry such as the introduction of machinery work considerable hardship on certain groups of workers, even though their general and long-run effects are beneficial. Economic progress has its social costs in unemployment. Its human effects in poverty must be ameliorated by social security, to be discussed in the following chapter.

A bad system of land tenure, such as that in England during the inclosure movement, in Ireland under its absentee landlords, or in Mexico in the era of peonage, also is productive of poverty. The United States was fortunate in its former abundance of free land. Indeed, the problem of poverty in this country can be said to date from the elimination of the frontier and the exhaustion of free land in the West. The rapid industrialization of the United States in the period following the Civil War was mitigated by the possibility of the displaced workers engaging in farming by taking possession of a homestead. Such an opportunity is no longer open to the displaced workers of the new industrial revolution.

Growth of population must be accompanied by the discovery of new processes and the better utilization of depleted resources. In the long run, the only way to preserve prosperity and to prevent poverty is to increase the productivity of industry. Planes of living are mere indicators of these two extremes, *i.e.*, relative abundance, or prosperity, and relative scarcity, or poverty, whether of nations or of families.

29–6. Standards of Living and Planes of Living. A standard of living is a composite of the quantities and qualities of food, clothing, shelter, and such other commodities and services as an individual, a family, or a group considers necessary to happiness. It can be expressed also in terms of money. This estimate is generally based on family, rather than individual, expenditure, for the family is the usual unit of economic consumption. Costs of attaining the same standard vary from time to time and from place to place.

A plane of living is likewise a measure of economic consumption, but it includes only what an individual or a family really does consume; whereas a standard of living is rather the idealization of a plane of living. The one represents a social aspiration, while the other constitutes a grim economic reality. Planes of living of many families frequently are below standards of decency and comfort.

Personal dissatisfaction and social unrest come only after a comparison of one's own plane of living with other and higher planes of living. It is true that poor but contented people are happier than rich but discontented people, because happiness is more a state of the mind than a condition of material well-being. The economist, however, finds it difficult to define and impossible to measure, such subjective concepts as individual happiness and social welfare. Prosperity can be expressed in terms of commodities and services, but happiness involves human emotions. Wealth is definable, but welfare is not. Hence our materialistic concept of standards and planes of living in terms of economic goods desired and consumed.

29–7. Variations in Planes of Living. Economic goods can be divided roughly into three groups: necessities, comforts, and luxuries. These three component elements of planes of living, like planes of living themselves,

are not sharply distinguished; they gradually fade into each other like the colors of the spectrum.

The plane of living of an unskilled laborer may include little more than the bare necessities of life, while that of his employer may embrace many comforts and some luxuries. Moreover, what is a necessity to a rich individual may be regarded as a comfort to one in moderate circumstances, and as a luxury to a poor person. There is one plane of living for Mrs. Wiggs of the Cabbage Patch and another for her friend, the Christmas Lady. Between these two extremes are innumerable variations and gradations, involving all kinds and degrees of comforts.

Planes of living vary not only among different income groups, but also among different nations. Thus we hear of an American plane of living, as compared with a European or a Chinese plane of living. Planes of living vary also from age to age, and the comforts of a middle-class family in England today are in marked contrast to those of the Elizabethan period.

In short, there is not just one plane of living, but there are many. They vary greatly, from place to place and from time to time; they expand as an individual or a group acquires additional desires and purchasing power.

29–8. Conditioning Elements. Planes of living are influenced both by what one desires and by what one is able to purchase. Human wants are on one side of the scale and income or wages on the other. The general price level is a third conditioning element.

Economists differentiate between real wages and money wages. A miser, like Silas Marner, finds supreme pleasure in counting his gold, but a normal individual desires the commodities or services that can be bought with money. Price inflation requires an equivalent increase in money wages if the customary plane of living is to be maintained. It has been said that prices go up the elevator, while wages slowly climb the stairway. On the other hand, price deflation, which increases the purchasing power of the workers' money wages, is often accompanied by an economic depression with consequent loss of employment and lowering of wages.

The determining or conditioning factors in planes of living can be stated differently. A basic factor is the physical environment, for the requirements of a cold and rigorous climate are different from those of a mild and fertile area. In arctic regions consumption requires furs, fats, and fuel, whereas in the tropics fruits and fresh air are more enjoyable. Another factor is social organization or the customs of the group, for institutions set the patterns of economic consumption. Finally, there is individual choice within the limitations of economic needs, social institutions, and monetary income. One must wear a shirt or a tunic according to custom, but the particular garment is one's own choice within his price range.

29–9. Family Budgets. Just as a nation or a city must balance its expenditures against its receipts from taxation, so the average family must

balance its total purchases against the combined wages of all its members. Any attempt to do so systematically may be called making a budget. A budget possesses the twin advantages of keeping expenditures within income and of establishing priorities in expenditure.

Economic consumption was formerly neglected, but of recent years some excellent studies have been made of family budgets. The commonly accepted unit of measurement is the family of four or five individuals, consisting of father, mother, and two or three dependent children.

The largest single item in family budgets has been found to be the expenditure for food. This ranges from about 50 per cent of total expenditures in the lowest income group to about 25 per cent for those in better circumstances. Rent and clothing vie for second place in the expenses of most families studied, and each averages from 15 to 18 per cent of the total expenditure. The amount spent for rent increases as we go up the social scale, but its proportion of the total income is remarkably constant. In the fourth place is the expenditure for heat and light, which varies from 5 to 8 per cent of the total costs of living. Transportation may be an important item in the expense account, according to the locality considered. The amount left for all other purposes varies from nothing or less than nothing, in the case of the very poor, to almost 50 per cent for those in moderate circumstances.

29–10. Engel's Law. As we go from the poorer groups to those in more comfortable circumstances, the amount spent for necessities of life, such as food and clothing, increases, but the percentage of total income so spent decreases. Therefore, the proportion as well as the absolute amount spent for all other purposes increases.

This margin of income above that required for the bare necessities of life is a test of the adequacy of a plane of living. In this reserve are included expenditures for recreation, amusement, insurance, saving, and incidentals.

A German statistician, Ernst Engel, in his study of Prussian family budgets, was the first to point out the varying proportions of income spent for various items by different income groups. Hence this relationship is known as "Engel's law." It states those generalizations concerning consumption that we have just observed. The higher income groups spend more for the necessities of life than do the poorer groups, but this relative part of their budget is less; their greater income permits them to spend relatively, as well as absolutely, more for incidentals and comforts. On the other hand, poor people spend absolutely less, but relatively more of their meager income for necessities.

The pressure of expenditures for the necessities of life on the family budgets of those in the lower income groups leaves only a small margin for saving. Recent studies reveal that the major portion of investment and

capital formation or replacement comes from the higher income groups. This corollary of Engel's law has sometimes been used as a defense of the rich classes, but it could also be utilized as a criticism of economic inequality.

29–11. Minimum Planes of Living. Students of family budgets have distinguished among different planes of living. Thus, there is the pauper-poverty plane of living, which is socially pathological or subnormal. The minimum-of-subsistence plane, which implies merely an animal existence with just enough to gratify the chief physical wants, is a concept that some early economists used. The minimum-of-health-and-comfort plane, which assumes an income sufficient to maintain health and working efficiency, is more modern and humane. It is broad and social in nature rather than merely physical or physiological in character. "Standard of health and decency" or "normal standard of living" are other terms for a similar concept.

29–12. Cost of Maintaining Minimum Standard. The United States Bureau of Labor Statistics [1] attempted to express a minimum standard of living in terms of monetary costs. Its estimate has been refined from time to time because of an expansion in the concept of standard of living, a decrease in the average size of the American family, and fluctuations in the general price level. On the basis of costs of living in 1914, at the outbreak of the First World War, it would appear that a mimimum standard of living for a small family, including father, mother, and two or three children, could be maintained on a yearly income of about $1,000; but in 1919 that same minimum standard required almost $2,000 or double the former sum. After the fall of prices in 1920, less money was needed, and following further deflation after 1929, still less money was required to maintain a minimum standard of living. Approximately $1,500 was a fair estimate for the low point of the depression. But costs of living again rose in the late thirties and the early forties. Consequently, the former estimate of $2,000 as the necessary cost of maintaining a small family at a minimum standard of health and decency again became conservative. With advancing standards, and rising costs, a minimum of $2,500 appeared to be more realistic for the Second World War. The removal of price controls thereafter was accompanied by rising prices that advanced such monetary estimates of a minimum standard of living for a small family to about $3,000.

29–13. Changes in Costs of Living. In the main, these follow fluctuations in the general price level, discussed in Chap. VII. Because the general pattern is so similar to the graph given therein, a diagram of changes in costs of living will not be included here. Table 3 on page 130 gives an index of costs of living, as well as one of wholesale prices.

[1] U.S. Bureau of Labor Statistics, "Tentative Quantity and Cost Budget," p. 6. See also *Monthly Labor Review*, June, 1920, pp. 1–18.

A cost-of-living index is a series of percentages representing changes in the prices of essential commodities and services. These are generally limited to necessities, but they may be expanded to include common comforts of life; luxuries are excluded. The index is generally weighed in proportion to the relative importance of the particular items in typical family budgets. It is computed from retail, not wholesale, prices for that is how the housewife buys her commodities.

Costs of living include not only the prices of necessary commodities but also payments for such essential services as rent, light, and heat, if not included in rent. Medical and dental bills also should be provided for, although people in the lower income groups neglect health care until or unless critical illness develops. Some taxes should be included, but workers pay many of them indirectly in their rents and other charges. Certain "overhead" costs of living, like interest on borrowed money, insurance premiums, and utility rates, vary less than commodity prices. Hence, an index of costs of living does not go up and down so far or so fast as one of general price level during periods of inflation and deflation.

A survey of changes in costs of living during the past generation shows movements similar in character to, although different in degree from, those of the general price level. Before the First World War, costs of living increased slowly; during and immediately after it, they jumped sharply to twice their prewar level. There was about a 20 per cent deflation from 1920 to 1922, after which costs of living stabilized until the great depression. From 1929 to 1933 was another period of deflation by about another 20 per cent; but the index did not fall to its prewar level, remaining instead about 20 per cent above it. Costs of living during the New Deal again rose slightly, until a short and modest decline occurred in the two years of the recession of 1937 and 1938. With the outbreak of the Second World War, costs of living rose steadily and substantially. But, whereas they had doubled during the First World War, costs of living increased by only a quarter or a third during the Second World War. Much of this retardation of the inflationary spiral was due to the imposition of price controls on such essentials as food, shelter, and clothing. With the prompt postwar relaxation of price controls on most items except rent there was a sharp increase in costs of living in 1946 and 1947. The previous good record was inherent in a situation wherein some goods were unobtainable and many goods were sold on the black market at higher prices than were permitted in the legitimate market. Both of these factors were necessarily ignored in the statistics of costs of living, although frankly admitted by the computers of such indices, who were unable to make mathematical allowances for them.

A picture of long-run changes in costs of living, as well as in wholesale prices, was given in Chart 4 in the earlier chapter on prices. A close-up of

what happened during the Second World War can be seen in Chart 16, which traces costs of living as a composite whole and also specific tendencies for particular items such as food and clothing. It will be observed how

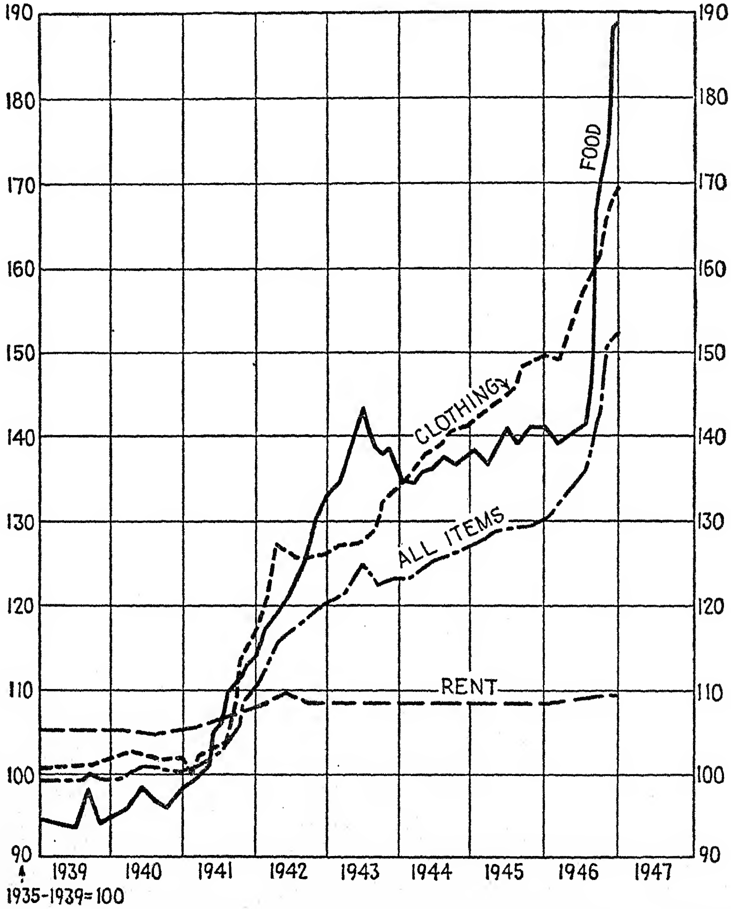

CHART 16. Costs of living during the Second World War. (*Data from the Department of Labor. Chart adapted from the Philadelphia Inquirer, Thursday, July* 9, 1947.)

rent control kept down the costs of shelter during the Second World War, in contrast to previous experience during the First World War.

29–14. Inadequacy of Wages. Many surveys of wages received, in relation to current costs of living, have been made. Although methods and findings differed from one study to another, from one period to another, from one community to another, and from one industry to another, there was, formerly at least, almost complete uniformity on the one common revelation of all these surveys; namely, the persistent inadequacy of the

wages of large groups of adult male workers to maintain decent standards of living for a family of husband, wife, and two or three children. The result was poverty or the gainful employment of mothers and children; in some cases it was both. The wages of most adult male workers were sufficient for self-support. The wages of women, however, were often inadequate, even for self-support, unless they lived at home with the adult male member of the family carrying the "overhead" costs of household support.

The new industrial revolution, as we have seen, increased production and enlarged the national income during the 1920's. Real wages as well as money wages rose markedly between 1921 and 1929. But they did not increase proportionately with the gain in industrial productivity. Finally, this period was not one of prosperity for agriculture. Even within industry itself, there were numerous low-wage areas in basic occupations and in large communities, particularly where workers were not organized into unions and where sweatshop conditions survived.

During the years of depression following the stock-market collapse of 1929, workers lost much of the modest gain in income achieved during the previous period of economic prosperity. Unemployment, as we shall see in the following chapter on economic insecurity, increased by millions. Although costs of living decreased, wage rates were often reduced in an easy and a highly competitive labor market. Standards of economic well-being, which had been slowly but steadily going forward, suddenly gave way and fell back to their previous low levels.

Some families were reduced from a plane of luxury to one of simple comforts or even the bare necessities of life by business failures and the collapse of the stock market. The families of many wage earners, however, fared even worse. Some were forced to relinquish comforts to which they had scarcely become accustomed, and even to reduce their modest expenditures for such essential items as food, clothing, shelter, and medical care. Still other families, which had been clinging precariously to a minimum standard of health and decency, were reduced to poverty or subnormal planes of living. As the ravages of the long and severe depression cut ever more deeply into the "submerged third" of our people, many were reduced to poverty, and some became dependents. Billions of dollars were expended by government for public works and relief.

29–15. National Industrial Recovery Act. The chief purpose of this emergency legislation of 1933 was to provide employment for the millions of people out of work, to restore, if possible, purchasing power to the great masses of our population, to regain decent working conditions, and to reduce the hours of work of those retaining their jobs by spreading employment to the less fortunate who were unemployed or irregularly employed.

Industrial codes attempted to specify minimum wages for workers in a

certain industry or a particular geographical area. The ideal was that of voluntary agreement in the payment of a living wage and in the maintenance of reasonable hours and decent working conditions. Submarginal firms that could not meet these minima, or exploiting employers who would not meet them, were to be eliminated. In order to prevent delay and to secure general compliance, a blanket code was put on all important industries until or unless they succeeded in formulating similar, approved, "voluntary" codes.

The National Industrial Recovery Act of 1933 was declared unconstitutional[1] in 1935. This heroic attempt by governmental fiat to raise wages and to shorten hours was abruptly terminated after only two years of experimentation. There is much to be said in favor of industrial codes, even though they are contrary in spirit to our antitrust policy, which was thus relaxed during the depression. Federal licensing, as pointed out in our previous discussion of monopolies, has its merits as a method of governmental regulation. But the alleged accomplishment of the National Industrial Recovery Act in raising real wages is debatable. Even during its short life, the NRA codes so increased costs of production that prices rose about as rapidly as did money wages. Some workers received less and not more real income. The economic moral appears to be that income or purchasing power must come from actual production of goods and not from artificial inflation of prices.

29-16. Fair Labor Standards Act. As the National Industrial Recovery Act was unconstitutional, the industrial codes drawn up under it were invalidated. Other legislation was therefore needed to accomplish their objectives. Consequently, the Fair Labor Standards Act, also known as the Minimum Wage and Maximum Hour Law, was passed in 1938. Like the National Industrial Recovery Act, it relied on the interstate commerce powers of the Federal government, but it was more specific in its provisions and did not delegate legislative power to the Chief Executive or to an administrative agency. Hence, it was declared constitutional by the Supreme Court.[2]

The Fair Labor Standards Act had three purposes: (1) to provide an exit for child labor; (2) to put a ceiling over hours; and (3) to place a floor under wages.

Children under sixteen years of age could not be employed in mines and manufactures. Young people, sixteen and seventeen years of age, could be employed only under certain conditions and in relatively safe and healthy industries.

[1] *A.L.A. Schechter Poultry Corporation et al. v. United States of America*, 295 U.S. 495 (1935).

[2] *United States v. Darby*, 61 S. Ct. 451 (1941); *Opp Cotton Mills Inc. et al. v. Administrator of Wage and Hour Division of Department of Labor*, 61 S. Ct. 525 (1941).

Maximum hours were prescribed as 44 for the first year, 42 hours for the second year, and 40 hours thereafter. In other words, since October, 1940, the United States has had a basic week of 40 hours for all industries engaged in interstate commerce. Despite considerable criticism, this standard was maintained throughout the Second World War. It should be remembered that a basic week of 40 hours does not prevent an employee from working longer hours. It provides merely that he be paid at the premium rate of time and a half for hours in excess of the maximum of 40 hours. It permits longer hours when necessary in an emergency, but provides a check against exploitation by unscrupulous employers.

The Fair Labor Standards Act prescribed a minimum wage of 25 cents an hour for workers (industrial and not agricultural) engaged in interstate commerce for the first year (1938–1939), a minimum wage of 30 cents an hour for the following 6 years, after which (Oct. 24, 1945) it was to become and to remain 40 cents an hour. Rising costs of living during the Second World War, however, had meanwhile outmoded this specific minimum-wage law, even though it still remained on the statute books. The War Labor Board, a temporary body created by executive order of the President of the United States, therefore lifted the minimum wage above its statutory level by several, successive advances. Shortly before the termination of the Second World War and even before the prescribed minimum wage of 40 cents had gone into effect, the War Labor Board decreed a minimum wage of 60 cents an hour, which was just double the current statutory minimum wage rate of 30 cents an hour.

At the end of the Second World War, the War Labor Board was abolished; its emergency decrees thereby were invalidated. The statutory minimum wage of 40 cents an hour then became the only permanent, legal floor under wages. In view of current costs of living and actual wage rates then prevailing, such a minimum-wage law meant little. One proposal, therefore, was to amend this law by raising the prescribed minimum wage to a more realistic level. The suggested figures of 65 cents and even 75 cents an hour then seemed moderate, as prices continued to rise. On the other hand, should deflation and depression set in, they might appear to be excessive. Another and perhaps a better plan, embodied in some minimum-wage laws, is merely to declare by statute the general principle of a minimum wage and to empower the Fair Labor Standards Administration to interpret it in monetary terms with power to define and redefine a minimum wage in accordance with changes in costs of living. Such legislation, however, has the obvious objections of ambiguity in language and concentration of administrative power. It also implies great confidence in the government's costs-of-living index. Finally continuous upward readjustment of minimum wages, adjusted for rising costs of living, would further contribute to the cost-price spiral. Downward readjustment would be opposed.

29–17. Wage Rates and Actual Earnings. Strictly speaking, a wage is a rate of pay per unit of time spent on the job or per piece of work completed. Earnings, on the contrary, are "take-home pay." Needless to say, planes of living depend on actual earnings rather than on basic wage rates.

To convert money earnings into real earnings, they must be refined for changes in the costs of living. But wage rates must first be turned into actual earnings by allowing for changes in the volume of employment. When jobs are scarce and work is irregular, actual earnings are low despite high wage rates. On the contrary, when employment is steady, modest wage rates yield substantial earnings.

The basic 40-hour week established by the Fair Labor Standards Act provided premium pay at time-and-a-half wage rate for overtime. Double time wage rates were frequent for work done on Sundays and holidays. During the industrial emergency of the Second World War, therefore, actual earnings of factory workers rose markedly, not only because of increases in wage rates and improvements in workers' classification, but also because of overtime pay under the 40-hour week law. The resultant increase in actual earnings or "take-home pay" however, as just indicated, was reduced by the rise in costs of living.

29–18. Trends of Industrial Earnings. Table 23 gives an index of factory pay rolls from the close of the First World War to the end of the Second World War. The first peak of industrial earnings, like that of costs

TABLE 23. INDEX OF FACTORY PAY ROLLS, 1919–1945 *

(Base, or 100 per cent, = 1939 level)

Year	Index	Year	Index	Year	Index
1919	103	1928	109	1937	109
1920	124	1929	117	1938	85
1921	80	1930	95	1939	100
1922	86	1931	72	1940	115
1923	108	1932	50	1941	168
1924	101	1933	53	1942	245
1925	107	1934	68	1943	334
1926	110	1935	79	1944	346
1927	108	1936	91	1945	288

* Federal Reserve Board *Bulletin.*

of living, appeared in 1920, after which came a sharp decline of about one-third during the depression of 1921, followed by a partial recovery within the next two years. From 1923 to 1929 was a period of relative stability

both in industrial earnings and in costs of living. However, the table indicates that, contrary to popular opinion, factory workers made only modest gains during the period of industrial prosperity of the twenties.

From 1929 to 1932 factory pay rolls fell by over one-half; the great depression cut savagely into money earnings, not only by lowered wage rates but also by reduced employment. Meanwhile, costs of living declined by only one-quarter. From 1932 to 1937, industrial earnings recovered almost to their previous 1929 level, while costs of living rose only moderately.

After a short but sharp recession in 1938, industrial earnings again began to climb. With the outbreak of European hostilities they jumped with amazing rapidity to unprecedented levels. At the end of the Second World War, factory pay rolls were about three times what they had been before its outbreak. Meanwhile, costs of living had increased by only about one-third. It must be remembered, however, that the number of workers on factory pay rolls had grown and that the number of hours worked had increased. The index of pay rolls is a very crude indicator of wage trends.

29–19. Postwar Situation. After the conclusion of hostilities, industrial workers, particularly those organized into strong unions, sought to retain the gains they had won during the Second World War. As much overtime was eliminated and hours of work were reduced, former earnings could be maintained only by substantial increases in wage rates. To maintain "take-home pay" in the face of rising costs of living, serious strikes took place in many basic industries. The disturbed industrial relations of 1946, as we shall see in the following part of this text, resulted in drastic labor legislation.

The immediate postwar situation was as follows. Weekly earnings of workers in manufacturing industries, despite a reduction in hours of work, increased 11.3 per cent between October, 1945, and October, 1946, whereas costs of living meanwhile rose 15.1 per cent. Earnings in manufacturing industries averaged $45.83 a week during the month of October, 1946, which was almost $5 above their weekly average for October, 1945, and only $1.50 below their wartime peak of January, 1945. The average work-week in October, 1946, however, was 1 hour below that for October, 1945, and about 5 hours below that for January, 1945.[1]

The obvious conclusion is that industrial earnings, which had greatly increased during the Second World War, were fairly well maintained in the immediate postwar period. As working hours were reduced, wage rates accordingly were increased. A second round of peaceful wage increases in 1947 followed those of 1946. With the return of the coal mines to private ownership in 1947, workers therein received the highest wages for the shortest working hours in the entire history of the industry. Real wages, however, showed no such substantial increase in the immediate postwar

[1] Survey by the U.S. Bureau of Labor Statistics.

period, because costs of living jumped with relaxation of price controls.

In summary of the long-run trend, the purchasing power of American factory workers doubled from 1913 to 1948. Average weekly earnings in current dollars went up from \$11 to \$51. Making allowance for rising costs of living within this period of 35 years, real weekly earnings in terms of 1913 dollars rose from \$11 in that year to \$22 in 1948.[1]

29–20. Short-run Tendencies of Wages, Prices, and Profits. Chart 17 shows that during the Second World War weekly earnings in manufactur-

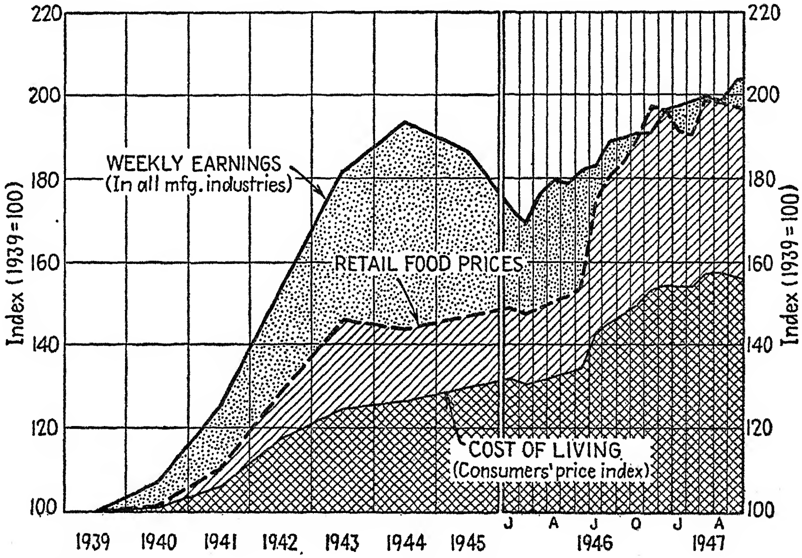

Chart 17. Wages and prices during the Second World War. (*Adapted from The New York Times, July* 13, 1947.)

ing industries kept ahead of rising costs of living, although retail food prices promptly caught up with increasing money earnings after the postwar relaxation of price controls over commodities.

Chart 18 pictures what happened to distribution during the Second World War. Average weekly earnings almost doubled, rising faster and farther than the prices of consumers' goods at retail. The profits of manufacturing corporations, even after taxes, doubled in the first two years, then declined to about the same level as prices at the end of the Second World War, after which they again rose sharply in 1946. The net income of agricultural proprietors showed the greatest and most sustained increase of all four lines.

[1] U.S. Department of Labor press release in *The New York Times*, Sunday, Feb. 29, 1948.

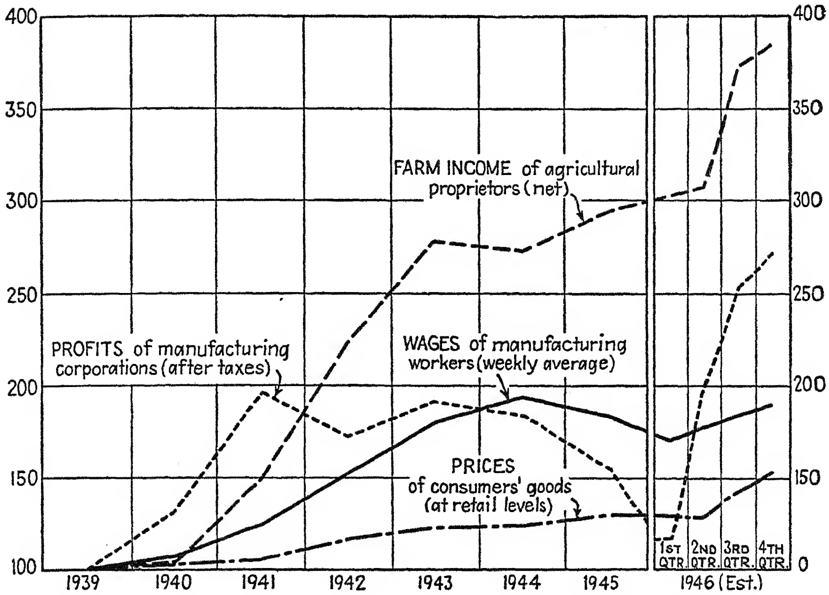

CHART 18. Distribution during the Second World War. Base (= 100 per cent) is 1939 level. Industry says that the relation between wages and prices must be calculated from 1939 to 1946; labor says that the starting point should be Jan. 1, 1945. (*Adapted from The New York Times, Sunday, Dec.* 22, 1946.)

29–21. Long-run Trends of Output and Hours. Chart 19 summarizes a significant study by the Twentieth Century Fund. It traces the long-run trends of working hours per week, of output per man-hours in cents, of employment in millions of employed people, and of the national income in billions of dollars at constant 1940 dollars. This factual study is economic history from 1850 to the Second World War, with a reasonable forecast thereafter to 1960 on the assumption of a continuation of previous trends.

The number of hours worked per week decreased from 70 hours, *i.e.*, roughly a 10-hour day in a 7-day week, in 1850, to slightly over 40 hours per week, *i.e.*, the equivalent of an 8-hour day in a 5-day week, in 1940, with the expectation of a continued decrease to less than 40 hours per week by 1960. This is the life line of national leisure, which should also be the mortality curve of exploitation rather than the rising menace of unemployment. After the end of the Second World War, as previously during the depression of the early thirties, many labor leaders urged the desirability and the practicability of a 30-hour week, in which people would work only 6 hours a day for 5 days in the week.

According to Chart 19, output per man-hour rose from midway between 15 and 20 cents' worth in 1850 to about 70 cents' worth in 1940, with the forecast of over $1 by 1960. This analysis of production may be viewed

somewhat similarly as the life line of national prosperity, which should likewise be a mortality curve of poverty.

The national income, according to this survey of the Twentieth Century Fund, rose from 5 billion dollars in 1850 to 80 billion dollars in 1940, with the conservative forecast of 125 billion dollars by 1960, all estimates being

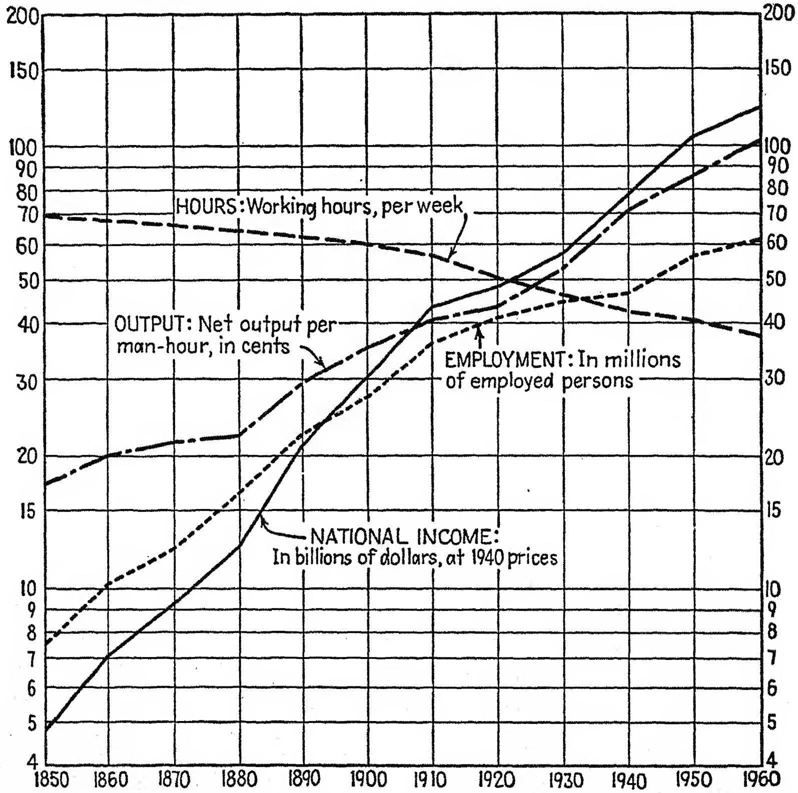

CHART 19. Economic trends in the United States, 1850 to 1960. Based on statistics covering the past hundred years, this chart projects the probable trends of the American economy more than a decade into the future. (*Data from "America's Needs and Resources," The Twentieth Century Fund. Adapted from The New York Times, Sunday, May* 4, 1947.)

expressed in constant 1940 dollars. If this analysis is accurate, the real income of the people of the United States has multiplied twentyfold and more over the past century. The number of people gainfully employed rose from almost 8 million in 1850 to almost 50 million in 1940, with the expectation of about 60 million gainfully employed by 1960. Thus, the number of gainfully employed workers also multiplied rapidly during the past century; but they increased less than tenfold, while the national income increased more than twentyfold, or easily twice as fast. Both increases, however, must be refined for occupational redistribution from nonrecorded self-

support or economic independence to gainful employment for others at reported wages.

29–22. Social Economics of Good Wages. In conclusion, let us summarize the disadvantages of low wages and the desirability of high wages without restriction of output and consequent inflation of commodity prices. Let us keep in mind our previous discussion of economic inequality and remember the necessity of meeting mass production with mass consumption to absorb the increased output of industry by substantial and sustained purchasing power well distributed throughout our entire population.

The social effects of low wages are poverty and subnormal planes of living. These, in turn, create other problems, such as those of women and children in industry. Insanitary housing, insufficient food, clothing, and medical attention are concomitants of low wages that result in an increased death rate.

Infant mortality is a fairly good barometer of planes of living. In certain American cities this was found to vary inversely, within certain limits, with the size of the family income. It was twice as great among the poor as in some of the higher income groups. Hence it was suggested that the inadequate wages of many workers be termed a dying wage, not a living wage.

The low wages of the heads of many families cast their shadow over the lives of all their members. Thus a large portion of children of pre-school age and of school age have been found to be undernourished. Many suffer from serious, but remedial, physical defects. Money spent for food and medical care is woefully inadequate. Hence, certain cities have maintained free distribution of milk, soup, or other foods to undernourished school children. Again, the physical examination of school children has been supplemented by free medical and dental services for those unable to pay. Although ignorance and indifference play an important part in ill-health, the significance of poverty and inadequate wages cannot be escaped.

The economic effects of low wages are as important as their social effects. Low wages are not synonymous with low labor costs. Labor costs are wages in proportion to productivity. Hence higher paid but more efficient workers may reduce, rather than increase, labor costs to management. Wages are higher in the United States than in Europe, but labor costs are not correspondingly higher. What the employer seeks are not low wages, but low labor costs. Industrial inefficiency is a cause of low wages, but it is also an effect of low wages with consequently low planes of living.

Low wages create discontent and reduce efficiency. Social unrest finds a fertile soil in the minds of poorly paid and irregularly employed workers. If the present economic order offers them no guarantee of a decent standard of living in return for loyalty, thrift, and industry, they are attracted by revolutionary proposals. Such disillusioned workers become ready

listeners to the glowing promises of radical leaders. On the other hand, steadily employed and well-paid workers, who own their own homes and who have savings in banks, are conservative and constructive elements in their communities.

Guide Questions on Text

1. Distinguish between poverty and pauperism.
2. Indicate the extent of each. Why is their determination difficult?
3. What do you understand by a standard of living and a plane of living?
4. Why are these concepts relative and not absolute?
5. Why are they social, rather than individual, concepts?
6. What are the chief conditioning elements of a standard of living?
7. What do you understand by a family budget?
8. State Engel's law and show its significance.
9. Outline various types of standards of living.
10. What is meant by the minimum-quantity standard of living?
11. What do you understand by a family wage? Is this a fair economic and social concept?
12. What evidence have you that the wages of a large portion of our adult male workers have been insufficient to support a family?
13. Is the problem of inadequate wages one of production, one of distribution, or both? Justify your position.
14. Outline some economic effects of low wages.
15. Outline some social effects of inadequate wages.
16. Enumerate some of the economic causes of poverty in addition to that of inadequate wages.
17. What is the distinction between subjective and objective causes of poverty? Is it valid? Why, or why not? Is it significant? Why, or why not?
18. Contrast the old and the new attitude toward poverty.

Topics for Investigation

1. Philanthropy and social insurance as weapons against poverty.
2. Charity organization societies and the profession of social work.
3. Concept of a family wage; *cf.* work of P. H. Douglas.
4. Early studies of poverty by Booth, Rowntree, and Hunter.
5. Sweatshops and attempts to eliminate them by minimum wage legislation.
6. Methods and conclusions of some investigations of wages in relation to costs of living. Trace trends of wages and test their adequacy.
7. Prepare a budget of your own income and expenditure or that of your family. Draw your own private conclusions.
8. Collapse of standards during the depression of the thirties.
9. Attempts to restore and to disseminate purchasing power under the National Industrial Recovery Administration.
10. Wages and earnings during the Second World War.

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CHAPTER XXX

THE BULWARK OF SOCIAL INSURANCE AGAINST ECONOMIC INSECURITY

30–1. Human Risks of Industry. In addition to the problems of economic inequality and inadequate planes of living, there is also the social menace of economic insecurity. These human risks of industry include the dangers of industrial accident, occupational disease, dependent old age, and unemployment. The margin of savings in the lower income groups is so slim that loss of wages is sufficient to drop them from economic independence into the social-debtor groups.

The risks of modern industry may be classified roughly into two grand divisions, (1) pecuniary or financial and (2) human or social. Financial risks fall largely on enterprisers, but not entirely so; this problem was discussed in Chap. V. The human risks of industry fall heavily upon workers; their reduction and provision for their victims are the central themes of this chapter.

Social insurance is a device by which the financial loss of earning power because of accident, sickness, unemployment, or old age is passed on to consumers or is diffused throughout society. Those who suffer the physical misfortune are compensated, in large part, by those who do not, at least not to so great a degree.

Although foreign wages have been lower than those in the United States, the European worker has enjoyed greater security than the American. In spite of the fact that other countries have been less prosperous than our own, some of them have suffered less from pauperism. The greater security of the European worker has been due to the wider prevalence there of various forms of social insurance.

30–2. Approach to Problem. The battle against economic insecurity, like that against most social evils, must be waged on two fronts. One objective is the elimination, or at least the reduction, of industrial insecurity by a conquest of its direct causes and by control over contributory factors. The other objective is the rehabilitation of the victims of industrial accidents, occupational diseases, prolonged unemployment, and other social hazards of modern economic life.

Such a program of rehabilitation presents three angles: (1) medical and surgical care for the restoration, as fully and as promptly as possible, of

physical health and fitness; (2) an educational, and perhaps a psychological, program for restoring morale and for retraining body and mind for other useful and remunerative occupations; and (3) financial compensation for temporary loss of, or permanent reduction in, earning power.

These methods of defense against industrial insecurity are pictured as a spearhead in Chart 20.

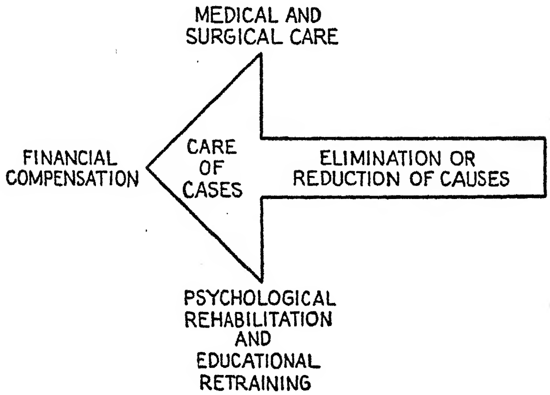

CHART 20. Spear of defense against economic insecurity.

30-3. Extent of Industrial Accidents. The absence of complete and reliable statistics makes it impossible to state definitely the number and severity of industrial accidents throughout the United States. The necessity and the accuracy of reporting them varies from state to state and from industry to industry.

Looking backward over the past few decades it would seem that the annual number of fatal accidents has been well over 100,000, divisible roughly into three fairly equal parts: (1) industrial accidents, (2) traffic accidents, and (3) common accidents at home. The number of serious nonfatal accidents runs into the millions each year. The annual number of all accidents within each of these three groups is several million apiece. These are merely the casualties of peaceful living and getting a living without including the casualties of war.

Such is the price that America is paying for speed, carelessness, indifference, and ignorance. Although safety measures and devices have been introduced, it would seem that the process of invention and discovery, accompanied by the introduction of ever more dangerous forces and methods, has gone on with even greater rapidity. Every consumable commodity or service may be said to have a computable cost in human suffering—a life for so many tons of coal or steel, a mangled hand for so many laundered shirts. The popular use of the automobile, as just indicated, has raised traffic accidents to a volume comparable with those of industry.

30–4. Causes of Industrial Accidents. Industrial accidents originate in the mechanized character of modern methods of production and in the failure of the human element in industry. Particular causes vary with individuals, occupations, and circumstances. Nevertheless, there are several general groups of recognized causes. These may be classed as mechanical, physiological, and psychological.

Modern technology makes use of new and powerful forces of nature, such as steam and electricity, whose power of destruction is as great as their power of production. Moreover, industry is now carried on with complicated machinery, rather than with simple tools. The average workman, who neither understands nor controls these machines, confines himself to one simple operation. He is in constant danger from the ignorance or carelessness of thousands of other specialists. The mistake of a railroad switchman or the carelessness of a fellow miner may result in the killing and maiming of thousands of other individuals. The interdependence of modern economic society is well illustrated in the matter of industrial accidents.

Furthermore, human nature is neither perfect nor automatic. Indeed, it does not seem to be well fitted for the tremendous task placed upon it by modern mechanization. The worker cannot adjust himself perfectly and promptly to the routine of his task, or to the continuous, rapid motions of the machine. Attention is bound to wander as fatigue sets in. The failure of the human mind to be continuously alert and to respond quickly and accurately is a contributory cause of industrial accidents.

30–5. Dangerous Trades and Occupational Diseases. The risks of the worker include his liability to subtle occupational diseases as well as to sudden industrial accidents. Dangerous trades include not only hazardous occupations, but also those which slowly but surely undermine the health of the worker. They result sometimes in specific diseases, but more often in a lowered vitality, which makes their victim an easy prey to ordinary sickness. Silicosis and lead poisoning are specific occupational diseases; but tuberculosis and pneumonia are general diseases, although they are especially common among some groups of workers.

Certain occupations may be classified as dangerous because of their physical effects upon the workers. Among them are industries that deal with poisonous substances, those in which the air is vitiated by dust or gas, and those which are subject to great changes in temperature, humidity, or air pressure. Their effects may be relatively rapid or slow, and of various degrees of severity.

30–6. Preventive and Remedial Action. The reduction of occupational diseases, like the prevention of industrial accidents, calls for concerted action by employees, employers, and the general public. A campaign of education is necessary to overcome ignorance and indifference.

Governmental legislation is similarly necessary, but uniformity is difficult because of differences in state laws. A dangerous trade may be driven

by law merely from one state to another. Legislative action should take the form of the abolition of most dangerous practices and the regulation of less dangerous ones. The United States Department of Labor has stigmatized certain jobs as dangerous. It has raised warning signs, popularized safety measures, and formulated codes of conduct.

Although sufferers from occupational diseases formerly were often excluded from the benefits of workmen's compensation laws, there has been a growing tendency to regard them in the same light as the victims of industrial accidents. They should not be thrown upon the human scrap heap of industry, nor be forced to resort to charity. As wounded veterans of industry, they should be provided for by social insurance.

30–7. General Sickness. It has been estimated that the average number of sick persons in the United States is continuously about 3 million, nearly one-third of whom are within the working period of life. This represents an annual loss in wages of 500 million dollars. If the costs of medical attention are added, the total economic loss from sickness approximates an even 1 billion dollars a year. Annual economic savings through the prevention of needless deaths, illness, and fatigue probably exceed 1.5 billion dollars at present, and may become several times as great.[1]

According to Dr. Fisk, of the Life Extension Institute, about half of this amount of general sickness can be prevented. In his contribution to the report on "Waste in Industry" is the observation that: "The 42,000,000 men and women gainfully employed probably lose on an average of more than 8 days each annually from illness disabilities, including nonindustrial accidents, a total of 350,000,000 days." Of the 500,000 workers who die each year "it is probably true that the death of at least one-half is postponable by proper medical supervision, periodical medical examination, health education, and commercial hygiene." [2]

Dr. Fisk contended that the average duration of human life in this country had been extended five years in the brief period from 1909 to 1922. This was accomplished chiefly by the reduction of infant mortality, the conquest of many contagious diseases, and the triumphs of modern surgery. But there has been an increase of mortality from chronic diseases of the heart, kidneys, and other organs, as a result of which the life expectancy of those in middle life was reduced by one whole year in the even briefer period from 1922 to 1927.

The new life-insurance table of 1941, put into effect in 1947, supplanted the older actuarial table of 1868. Under the old table, children reaching one year of age had a life expectancy of 48.94 years, but under the new table one of 63.76 years. For people reaching 20 years of age, the old table

[1] Fisher, Irving, "National Vitality: Its Wastes and Conservation," pp. 741 and 742, Superintendent of Documents, Government Printing Office, Washington, D. C., 1910.

[2] Federated American Engineering Societies, "Report of Committee on Waste in Industry," p. 21, Washington, D. C., 1921.

gave them 42.20 additional years; the new table gives them 46.54 more years.

30–8. Public-health Movement. The responsibility for excessive sickness and premature death rests not only on industry, but also on both the individual and the community. One of the most significant developments of the day is the public-health movement, which seeks to reduce the excessive amount of illness and to lengthen the span of human life. Like the safety-first movement, it should be fostered by employer and employee, management and union, the family, school, and state. Personal hygiene and public-health measures, however, do not keep pace with the discoveries of medical science. Although much is being accomplished, far more could be done by an aroused public opinion seeking to apply the teachings of public hygiene.

Adequate medical, surgical, and dental care should be provided for all individuals and families without mass production methods and without destruction of the personal and professional relationship between physician and patient. If protection from foreign invasion and domestic disorder is an obligation of the state, protection from the ravages of disease is similarly its function. If provision for public education by means of a free school system is a duty of the state, provision for public health by means of free hospitals and clinics is equally logical. Public care would supplement, not supplant, private institutions and practicing physicians, just as public schools now flourish along with private and parochial schools.

One of the greatest conservation problems of industry in particular and of society in general is that of human conservation, or the preservation of national vitality and physical fitness. Inasmuch as sickness and poor health are important causes of industrial inefficiency, an expenditure of public funds or corporate earnings in the interest of human conservation might be a wise investment. Pay-roll deductions are now made for old-age annuities. Why not for medical care to keep well and to live long? Moreover, sickness is an important cause of dependency. Hence, a health program should be supplemented by some sort of sickness insurance for all workers, just as the safety-first movement has been supplemented by workmen's compensation laws.

Such a forward step has been taken in Associated Hospital Service, more popularly known as the Blue Cross. Just as the Red Cross stands for first aid to the injured, and the green light indicates safety ahead, so the Blue Cross symbolizes financial preparation for the hazard of hospitalization. The Blue Cross is not socialized medicine but merely a form of group insurance to cover, in part at least, hospital costs in the event of serious accident or illness. Most employees of large organizations may elect membership and authorize therefor pay-roll deductions. The Blue Shield is a later but similar and associated form of group insurance, which provides some physicians' fees at scheduled rates for certain types of illness.

30–9. Nature and Kinds of Unemployment. The risks of labor include not only industrial accidents and sickness, but also unemployment. This may be defined as idleness on the part of the worker that is not due to his own physical, mental, or moral incapacity.

It is important to differentiate between the unemployed and the unemployable. The former are a concern of economics, and the latter of sociology. The unemployed, as contrasted with the unemployable members of society, are those workers who are capable of labor, but who are unable to obtain employment because of some maladjustment in the economic order over which they have little or no control.

Unemployment is enforced idleness, due to lack of effective demand for a certain type or several types of labor. A vacation, on the other hand, is a voluntary cessation of work for the purpose of mental or physical recreation. Unemployment is due to a shutdown because of lack of work. A lockout or a walkout is due to industrial friction.

Excessive hours in one occupation with unemployment in another represents a maldistribution of industry. There can be inequality in the distribution of leisure as well as of income. A continuation of unemployment in a large group of idle people, be they rich or poor, is as detrimental to society as a concentration of income in a small propertied class. A wide distribution of productive work is as desirable as a wide distribution of wealth.

Irregular employment and underemployment are phases of the general unemployment problem in which the worker is not steadily employed, but loses a great deal of time from work. For illustration, many coal mines do not operate continuously all days in the week or all weeks in the year. Underemployment is irregularity or lack of employment to the extent that the worker is unable to earn wages sufficient to maintain a minimum standard of living. He is reduced to the level of poverty or pauperism. The irregularly employed or the long unemployed worker gradually becomes unemployable.

Unemployment may be casual, seasonal, cyclical, or technological. Casual unemployment is represented by day-to-day or week-to-week fluctuations in employment. It may be illustrated by the irregular employment of dock workers and domestic helpers. Seasonal unemployment is that due to monthly or quarterly variations in conditions of production, such as in lumbering or canning, and to seasonal changes in the demand for special products such as clothing or holiday goods. Cyclical unemployment is that due to recurrent periods of business depression which take place every few years. Technological unemployment is that due to the mechanization of industry and the substitution of machines for men.

The chief aim formerly was to provide means of temporary relief, rather than to analyze the causes of this economic problem in an effort to eliminate or to reduce it. But in recent years a number of excellent studies have been

made by various public and private agencies of the nature, types, amount, causes, and effects of unemployment.

30–10. Amount of Unemployment. Because of great variations in the volume of unemployment among different occupations, industries, seasons, and phases of the business cycle, it is difficult to make a general estimate of the amount of unemployment. The average number of unemployed, or the average rate of unemployment, is as meaningless a statistical abstraction as the average wage of all workers or the average temperature of all sick people.

It is generally conceded that unemployment, especially casual unemployment, is greater in unskilled than in skilled occupations. Again, the problem is more acute in winter than in summer, when agriculture takes in a certain amount of the slack. Unemployment also displays itself more intensively in the city than in the country. There is a tendency of unemployed or migratory labor to flock to our cities during the winter months and then to flow out again into the country during the spring and summer. In the meantime, urban demands on charity are taxed to the utmost.

A review of various American estimates of unemployment gave rise to the summary that an average of at least 1,500,000 industrial wage earners in the United States are continually unemployed, taking poor and prosperous years together, and that the average worker loses about 10 per cent of his working time through unemployment alone.[1]

In Beveridge's classic study of unemployment is the conclusion that, although the volume of unemployment increases greatly during periods of economic depression and decreases in periods of prosperity, there is a continuous but varying amount of unemployment throughout all phases of the business cycle. Other studies of the problem of unemployment likewise indicate that it is a chronic, as well as an acute, problem. In other words, unemployment never disappears; it merely gets relatively better or worse from time to time, or it is comparatively mild or severe in one industry or area as compared with another. In spite of popular opinion to the contrary, a period of prosperity does not entirely eliminate unemployment, even though it does reduce its amount.

Many studies indicate that employment did not keep pace with industrial production during the new industrial revolution in the United States. There was considerable evidence of a secular trend toward increasing technological unemployment, or at least toward greater irregularity of employment.

During the depression years of the early thirties, the volume of cyclical unemployment rose to a figure somewhere between 10 and 15 millions; perhaps 12 million would be a conservative estimate. The New Deal en-

[1] BRADFORD, E. S., "Industrial Unemployment," p. 2, U. S. Bureau of Labor Statistics, *Bulletin* 310.

gaged in a vast program of public work and expended huge sums for relief. During the Second World War, as during the First World War, the volume of industrial employment was greatly expanded. Unemployment was reduced to a minimum, but it was not completely eliminated.

30-11. General Causes of Unemployment. The causes of unemployment, like those of poverty, can be divided into objective or environmental causes and into subjective or personal causes. But, as shown in the preceding chapter, these are merely different ways of analyzing the same set of factors. Individual causes are concerned not so much with the fact of employment as with its incidence. Personal causes do not determine so much the existence or the amount of unemployment as they do its incidence, *i.e.*, who are most likely to suffer by the impact of an uncontrollable wave of unemployment, if the principle of seniority does not hold. Individual, contributory causes of unemployment include intemperance, crime, indolence, disease, degeneracy, old age, and various physical, mental, or moral defects. These factors, however, need not be stressed, for they are more important in a causal analysis of the unemployable group than of the unemployed group.

Objective causes of unemployment are found both in the physical and in the social environment. Any such classification is similarly reciprocal in character, because man can modify his natural habitat, and, in turn, he is influenced by it.

Under the physical environment may be mentioned such factors as floods, earthquakes, storms, and droughts. The vagaries of the weather can create temporary unemployment or feverish employment. A flood may incapacitate local industries and put those workers out of their jobs. On the other hand, a snowstorm gives work to the idle, if an unemployed labor reserve exists at a particular time and place. Of course, a snowstorm or hailstorm cannot be regarded as a social blessing, for, had it not occurred, it would have been possible to put at other productive tasks workers otherwise employed in shoveling snow or putting in panes of glass. Here, we face the persistent "lump-of-labor" fallacy.

Under the social environment may be mentioned direct or contributory causes of unemployment lying in our institutions. Thus war always has a disturbing influence, causing a temporary or a permanent readjustment. In its wake comes acute or chronic unemployment in some places and industries, but perhaps increased employment elsewhere. During the American Civil War, for illustration, many cotton mills of England were closed and thousands of English textile workers were thrown out of employment. The First World War caused even more serious maladjustments in international trade, which produced a postwar condition of unemployment in

Great Britain due to the languishing of important export industries. The Second World War accelerated employment in the United States and created new industries, such as that of synthetic rubber.

The most important and direct causes of unemployment, however, are to be found in our economic organization. Even a cursory survey of this problem would be incomplete without some discussion of the following causal factors: disturbance in equilibrium of the demand for and the supply of labor, improvements in methods of production, changes in the demands of consumers, seasonal occupations, and the business cycle.

30–12. Disturbance of Labor Demand-and-supply Equilibrium. Unemployment is peculiarly a modern problem of our specialized economic society, resting on division of labor and exchange. Unemployment in the strict sense of the word did not exist in a simple economic order where production was direct rather than roundabout, and where producer and consumer were identical. The American pioneer, for example, was his own butcher, baker, and candlestick maker. He used his own time at his own discretion for the production of such goods as were necessary to the satisfaction of his few wants. Capital took the form of simple tools, not expensive machinery. Enforced labor by servitude and independent or self-employment were common. In the absence of an elaborate wage system the worker was his own employer, not greatly concerned with distant markets and general industrial conditions. The economic forces of supply and demand were crystallized in his own person. If out of work, he could push on West in search of greater opportunity or adventure. Hence, there was little unemployment.

a. Influence of Specialization. The frontier has long since disappeared from American life; modern industrialism has taken its place. Economic evolution has resulted in the transition from a simple to a complex society, and from an undifferentiated to a highly specialized economy. Today, few people satisfy directly by their own labor very many of their economic wants. On the contrary, most individuals daily consume the products of thousands of different specialized workers whom they have never seen. Likewise, they limit their own efforts to the production of one economic good, or, rather, to one particular phase of its production. The growth of this great cooperation of specialists has been accompanied necessarily by the development of a very intricate mechanism of exchange. Regularity of employment now depends on the nicety of adjustment between the consumption and production of countless economic commodities and services made by innumerable specialists who are unknown to each other and who work independently.

Division of labor has made possible the production of more goods, cheaper goods, and, perhaps, better goods; but it is fraught with certain grave dangers, one of which is that of unemployment. As long as this

delicate machinery of specialization and exchange works smoothly, all is well; but if friction occurs in some parts, the whole mechanism suffers. A Swiss watch is a better timepiece than a sundial, but it gets out of repair more easily. Similarly, modern industry is more productive than our primitive economy, but it is less stable.

Standards of living are higher today than before the Industrial Revolution and the poor man's table has on it comforts from all parts of the world. Nevertheless, this very interdependence of our modern economic world makes it a veritable house of cards. Thus a strike among the coal miners of Pennsylvania may force New England textile mills to close, and a drought in Argentina may put London dock hands out of work. We have passed from a local to a national economy, and from a national to an international economy. American tariffs and German reparations decidedly affected the unemployment problem in England after the First World War.

b. Roundabout Production in Advance of Demand. Not only is there division of labor among individuals and among territories but also over periods of time. Modern economic production is not only specialized but also roundabout and capitalistic. Labor was formerly applied directly to natural resources for the production of finished consumption goods. Today, labor first spends itself on the production of capital, and then, aided by the use of these capital goods, labor turns toward the final production of the desired consumption goods. Capitalistic or roundabout production is far more effective than the direct method, but it is more susceptible of misdirection. In such a case, great economic and human loss results, not the least of which is that of unemployment.

Between raw materials of production and finished consumption goods, many stages interpose. Iron ore may be mined this year, made into ingots a year hence, fabricated into steel girders still further in the future, but not used in building construction for several years. Because capitalistic production is roundabout and time consuming, and because producers must prepare for a prospective future demand rather than for an actual present market, production must be carried on in anticipation of demand rather than in response to it. This necessary condition enhances the possibility of error in production and the seriousness of changes in consumers' wants. Because modern production is spread out over a long period of time, the original wants of prospective consumers may change in the meantime. The demand, in anticipation of which production has been carried on, may vanish.

c. Misdirected Production. Although general overproduction is impossible, because human wants are unlimited and more goods cannot be produced than can be consumed, it is possible to have misdirected production, *i.e.*, the production of too much of one good and not enough of another in proportion to their relative demands. Again, overproduction of

one good or of many goods is possible in the sense that more can be made than can be sold at a profit above costs of production. Misdirected production, hoarded savings, or underconsumption, as reflected in price disturbance or price deflation, are contributory causes of business depressions that disturb the delicate equilibrium between the demand for labor and the supply of labor, thus causing unemployment or increasing any existing unemployment.

Of course, labor creates its own demand for its own products. In the final analysis, all producers are consumers and most consumers are producers. In the long run, the demand for labor must balance the supply of labor. This economic principle, however, like any other scientific law, merely states a general tendency. There are numerous opposing forces and disturbing influences, for modern industrial society is complex and not simple, dynamic and not static. At any given time and place, there may not be a perfect balance between demand and supply forces. There can be a temporary and local lump of some kind of labor like the glut of a certain economic good. There often exist unbalanced industries, unbalanced localities, and unbalanced periods. Thus the maladjustment of unemployment will continue to display itself, now here and now there, but always somewhere. It may be temporary, local, or particular, *i.e.*, affecting only a given time, a given industry, or a given group of workers, but for society in general the maladjustment is continuous and ubiquitous.

A dynamic, complex, and interdependent society may reduce unemployment through better industrial planning, but it is almost impossible to eliminate it. The danger of unemployment is inherent in our specialized, interdependent, and capitalistic economy, in which production is carried on in advance of demand by individual initiative, rather than by cooperative group planning. The price system, like an economic thermostat, is an effective regulator of production and consumption, but it does not function perfectly and immediately. Hence maladjustments exist and unemployment continues.

d. Economic Freedom and Automatic Price Adjustment. Finally, unemployment is a characteristic of a free society; it is a price of economic liberty. A slave society would tolerate no unemployment, at least not among its slaves, for it would be costly to the slave owners. It is true that Hitler solved Germany's unemployment problem, but he did so by putting the unemployed in his military or industrial armies. The cure was worse than the disease. A totalitarian and communistic state likewise could eliminate unemployment by providing vast public works projects and by compelling employment upon them. A democratic society would not resort to such compulsion, even though it should plan public works programs to take up the slack when private industry fails to provide employment for all those who are able and willing to work. A free economy of private enterprise and

individual initiative suffers from maladjustments in the demand for and the supply of labor.

30–13. Invention of Machinery. The invention of printing reduced the demand for scribes, but it created a new demand for printers. The invention of the locomotive reduced employment among carters and bargemen, but it created still more work for many more railroad employees. The advent of the automobile reduced the number of livery stables and the output of buggy whips, but it brought into being a vast new industry with a far greater volume of production and employment.

It is contended that this unemployment is merely temporary and that the discharged workers will find employment in other fields. Each new invention reduces the cost of production, and, hence, it lowers the price of the article produced. Therefore, it tends to leave more purchasing power in the hands of consumers with which to buy other products or more of the same product. The ultimate and total demand for labor is not reduced thereby, for displaced workers will eventually find reemployment. The process of adjustment may be painful to the group of workers affected, but it is only temporary or local.

The invention of power machinery and the introduction of new processes, however, work a severe hardship on the skilled worker who has spent years in learning his trade and who is now forced to seek a new one. If he is too old or otherwise incapable of making the necessary adjustment, he may suffer a permanent loss of employment or he may be forced to accept the lower wages of a less remunerative job. The greater economic wellbeing of society as a whole, however, is of more importance than the special interests of any particular group.

30–14. Changes in Wants of Consumers. Changes in fashion are social in origin, but they have important economic effects. Inasmuch as production must be carried on in anticipation of demand, rather than in response to it, sudden and unforeseen changes in the wants of consumers cause misdirected production. Although the consumer may be unaware of these economic wastes and social costs, they are tremendous. In some shops there are unemployed workers and idle capital, while in other establishments overtime and night work are necessary to keep up with the latest public craze.

Increased standardization of consumption goods and greater stability of economic wants would reduce this waste. Consumers could benefit thereby in the form of more goods, better goods, and cheaper goods. Employers also would profit thereby through a decrease in the uncertainties of business and a reduction in the obsolescence of machinery and other equipment. Finally, workers would enjoy greater security from the constant menaces of unemployment, on the one hand, and overtime, on the other.

Complete standardization and perfect stabilization are undesirable and impossible. Some variety and change in such consumers' goods as food, clothing, and furnishings are desirable. On the other hand, standardization of capital goods, and of gadgets such as electric sockets and fixtures, makes for economy and efficiency. Mass production methods, involving standardization of parts and processes, gave us good automobiles at low prices. It did not, however, stabilize employment.

30–15. Seasonal Occupations. Seasonal unemployment is due to periodic variations within the year in the demand for labor of a given type, due to seasonal conditions of production or consumption. Thus, wheat must be harvested when it is ripe and vegetables must be canned before they spoil. Building can be done more economically in the warm months, but lumbering is easier in the winter. Consumers' wants likewise are subject to seasonal variations in quantity and quality. The clothing and millinery industries, for illustration, have fall and spring seasons, owing to periodic changes in temperature; the intervening summer and winter months are less important fashion seasons.

Where the seasonal character of an industry is due to the effects of alternating weather conditions on production, stabilization of employment is difficult. Thus, the production of ice was necessarily a winter industry before natural ice was supplemented by artificial ice and electrical refrigeration. Lumbering still remains chiefly a winter industry where logs are sledged down to the mills or rivers. Construction work and the building trades flourish in the spring, summer, and autumn, but they languish in the winter months when cold, frost, snow, and sleet make outdoor work difficult, dangerous, and subject to delays. On the other hand, seasonal changes in consumption can be anticipated to a considerable degree, although extensive production, far in advance of demand, is expensive and dangerous.

The dovetailing of seasonal industries tends to reduce their disastrous effects on regularity of employment. Hence the common combination of coal and ice dealers was beneficial, for the employer could maintain a year-round force of workers, most of whom could deliver ice in summer and coal in winter. It is obvious, however, that there are numerous limitations to such a dovetailing of industries. It is peculiarly difficult where the occupations are unrelated or where they call for a considerable degree of skill. Thus it is impossible for printers to become carpenters in order to balance the seasonal character of these very different industries. Even if such mobility of labor could be secured, it would not completely solve the problem. The total demand for all workers appears to be greater in some months than in others. Time, like specialization, is a factor.

Although dovetailing seasonal industries, wherever possible, would help to stabilize employment, little has been done in this respect. Instead of a

conscious planning of industries, which might take in a portion of the unemployed labor during slack seasons, the tendency has been for each industry to build up its own labor reserve, which can be utilized in full only during busy seasons. Moreover, trade unions limit the work done by their members and oppose the entrance of other craftsmen into their own occupations.

30–16. Effects of Business Cycles. Unemployment due to a general period of business depression must be distinguished from that due to seasonal industries. Here we are again face to face with the great economic problem of the business cycle. It will be remembered from Chap. X that a period of business prosperity tends to culminate in a crisis, which is succeeded by business depression, followed, in turn, by slow recovery. This gradually develops into a period of prosperity, and so on again, through these successive phases of the business cycle, which tend to repeat themselves at varying intervals.

The great human tragedy of a business depression has been unemployment. Thousands of idle workers have tramped the streets vainly in search of employment. Soup kitchens and bread lines were their former features; still more recently, apple selling and relief rolls have been added. Moreover, unemployment creates more unemployment. When large numbers of workers are thrown out of their jobs, there is a serious loss of wages, which means not only misery to the unemployed but also a reduction of purchasing power within the community. This decrease in effective demand accentuates the business depression, as unemployment creates still more unemployment.

30–17. Social Costs of Unemployment. Although unemployment is costly to employers and to society in general, its chief burden rests on labor. To the worker, unemployment means loss of wages and, consequently, a lowered plane of living. As his meager savings are soon exhausted, the man out of work faces the unpleasant alternatives of poverty or charity.

Unemployment affects other workers besides the unemployed, because a general wage reduction is apt to occur. Discharged laborers tend to seek employment elsewhere in other occupations where increased requests for employment lead to the cutting of wages. Individuals out of employment often work for less money than they formerly received, and for lower wages than those workers to whose jobs they aspire.

Unemployment has a depressing influence on the idle worker, as well as a demoralizing effect on the labor market. Irregular employment jeopardizes steady habits of thrift and industry. It is easy for those out of work to drift with the current into the great river of casual and migratory laborers. It is natural for the unemployed or the irregularly employed eventually to float out into the vast sea of poverty and pauperism. The degeneration of a casual or migratory laborer into a tramp, a delinquent,

or a dependent is as easy as his later restoration into a steady and industrious worker is difficult.

Unemployment is costly to the employer as well as to the employee. Although management has a greater financial reserve than labor, a closed factory pays no dividends. Overhead charges, such as interest on idle capital, run on and soon exhaust the surplus from past earnings. Moreover, the "laying off" of workers tends to break up an employer's organization, and its general efficiency is lower when production is resumed. Even under normal operation of industry, labor turnover, or the continual "hiring and firing" of workers is expensive.

The economic costs of unemployment to society in general also are important. Unemployment creates more unemployment. The majority of consumers are wage earners, and unemployment reduces their purchasing power. Consequently, their effective demand for various economic goods declines and production falls off proportionally. This, in turn, creates more unemployment and the vicious circle is complete.

The social costs of unemployment may be read in the rates of crime and poverty. Unemployment is both a cause and a result of dependency and delinquency. A period of industrial depression, with consequent loss of employment, will increase greatly the demands on public charity. There is also apt to be an increase in petty crimes against property, if not in more serious crimes against person.

Unemployment among adult male workers has been either a direct or a contributory cause of child labor and of the entrance of women into industry. The desire to supplement the family income led to the employment of women and children under sweatshop conditions. The entire labor market became "easy."

Unemployment breeds discontent, radicalism, and a general spirit of unrest against the existing economic order. Workers who are able and willing to work but unable to find employment are easy converts to revolutionary doctrines and disorderly actions. On the other hand, regularity of employment and a living wage are the best practical arguments among laborers in the defense of the *status quo* of modern industrialism.

30–18. Reduction of Unemployment by Private Enterprise. Philanthropy merely affords temporary relief for the unemployed, and charity is a poor substitute for the "right to a job." Although governmental action is necessary to alleviate a depression, industrial management must seek to reduce unemployment, which is a challenge to capitalism and a test of the free enterprise system. A scientific attack on unemployment, like that on poverty, begins with a causal analysis. Our brief survey of some of the chief economic causes of unemployment suggests remedial measures.

Reduction or anticipation of changes in fashion would ameliorate industrial instability, which results in overtime on the one hand and unem-

ployment on the other. Popular education of men and women on this subject might do some good. Anything which tends to stabilize demand helps to reduce unemployment. In general, the demand for necessities is more stable than that for luxuries. Hence, the proposition "necessities for all before luxuries for the few" has a corollary on unemployment.

The growth of large business combinations may reduce fluctuations in the demand for labor. Monopoly price is apt to be higher but more stable than a corresponding competitive price. Moreover, with an expansion of the business unit, the opportunities to correlate different occupations is increased. There is less tendency for each industry to create its own labor reserve of workers who are utilized in busy seasons, but unemployed in slack times. There is greater opportunity to transfer workers and greater possibility to diversify output and to manufacture for stock.

The seasonal aspect of those industries determined by physiographic influences cannot be eliminated. Nevertheless, much can be done to dovetail seasonal and separate occupations. One-industry towns and seasonal-industry communities, in particular, should seek other and supplemental occupations, especially for employment in slack periods.

The correlation of industries reduces unemployment. An illustration is farming in spring, summer, and autumn, with lumbering in winter, by the same corps of workers. But this merely substitutes the problem of migratory labor for that of unemployed labor. A better plan would be to correlate industry with agriculture. Some small industries have moved to the country; some large industrialists, like the late Henry Ford, have urged home gardens for factory workers.

Irregularity of employment can be reduced by advance manufacture for stock, instead of in response to custom orders. The clothing industry is an outstanding example of regularization of employment with improvement in working conditions, as the industry advanced from sweatshops and homework to standardized and stabilized factory production. Such a procedure increases the hazards of producers because it intensifies the risk due to possible changes in consumers' wants. It was formerly the practice of employers to pass on this uncertainty to their employees in the form of irregular employment, involving overtime in rush seasons and unemployment or underemployment in slack seasons.

It is easier and safer to manufacture staples for stock than it is to produce fashion goods in advance. Uncertainties are less in the former type of industry than in the latter, but greater stabilization can be secured in each type than exists at present. By offering special discounts to advance purchasers of novelties, the financial outlays and risks of those enterprisers might be reduced. It has been a common practice of coal dealers to sell at lower rates in the spring and summer than in the fall and winter. If the householder will store coal in his own cellar when his furnace is not in use,

he will help to stabilize production and employment in the anthracite areas. Although coal was formerly a staple of industry, the occupation of mining was never stabilized.

30–19. Economic and Educational Reforms. Consideration of the reduction of unemployment due to industrial depressions takes us back again to the problem of business cycles. This, in turn, it will be remembered from Chap. X, involves issues of money, credit, banking, and price levels. Without reviewing these factors, it may be said that any economic reforms that tend to eliminate, or even to ameliorate, business depressions tend proportionately to reduce cyclical unemployment.

The invention of machinery and other technological changes will probably continue in the future as they have in the past. Indeed, economic progress is apt to be accelerated. A dynamic society faces a constant process of adjustment. It is hoped, however, that technological advances will be accompanied by increased social control over industry, and that adjustments will be conscious adaptations in the light of ethical considerations, with social welfare given greater consideration than private gain. The scrapping of human machinery cannot be viewed with the same complacency in the future as in the past.

Educational, as well as economic, reform is necessary. It is costly for society to have its capable youth in blind-alley jobs and not in school. Educational programs should be sufficiently varied to appeal to different types of human abilities and to prepare for all sorts of industrial opportunities. Some educators prefer general industrial or commercial education to specific trade schools, feeling that we have gone too far in the matter of extreme specialization. There is a dearth of the all-around mechanic. It is hoped that education within and without the schools will increase not only the skill, but also the mobility, of future wage earners. This will enable them to shift more readily from one occupation to another. Industrial opportunity lies with the adaptable, or "double-barreled," man. It has even been suggested that an individual learn two allied trades instead of one specialized occupation.

30–20. Public Employment Bureaus. Employment agencies cannot reduce unemployment by creating work, but they can aid in bringing together the jobless man and the manless job. They can reduce the aimless wandering of men out of work. Private employment agencies conducted for profit have been operated for many decades. Public employment bureaus supplementing them are more recent.

Most American states have passed statutes to regulate private employment agencies, for serious abuses were formerly common among them. Many states also have provided their own public employment bureaus, some of which are fairly successful. An attempt to eliminate by state law private employment agencies was held to be unconstitutional. During the two world wars, the Federal government inaugurated a nationwide system

of labor exchanges that functioned with remarkable success until their appropriations were cut in waves of postwar economy.

30–21. Public Employment. Public employment during periods of industrial depression not only gives jobs to those out of work, but also has a stimulating influence upon other industries. Thus, to employ men upon the construction of roads and buildings is also to create a demand for stone, cement, and structural steel. The indirect influence of public work on unemployment is as great as its direct influence. Society is the gainer, not only because of lessened appeals to charity, but also because of the economic savings resulting from having construction done in periods of low prices.

Unfortunately, many governments follow the example of private business. They spend and expand in periods of prosperity; they retrench in periods of depression when taxpayers feel poor. The result is an accentuation of the business cycle instead of a moderation of it.

Another mistake of the past has been the failure to plan ahead for municipal, state, and Federal projects. American cities, as a rule, have not had their future development planned in advance. They have just grown. It is not surprising, therefore, that the employment on public improvements of those out of work has not been very efficiently done. Nevertheless, such public employment has alleviated temporary distress.

The Roosevelt recovery program included enormous expenditures for public work in addition to those for relief. Billions of dollars were spent by the Public Works Administration, the Civil Works Administration, the Civilian Conservation Corps, and the Works Progress Administration. Much of it was hastily conceived and poorly administered, but most of it was of some social benefit.

Finally, public work that is poorly timed is as undesirable as that which is poorly planned and badly administered. Public work in a period of prosperity diverts employment from private enterprise; it does not create jobs. Again, it is inflationary in character, as it stimulates still further rising prices. Public employment should be viewed as a stabilizing influence on the business cycle, rather than as a make-work panacea for all periods and conditions.

30–22. Social Insurance. *a. Need.* Early economists and statesmen held that workmen should provide for themselves against the various risks of industry. They stressed individual thrift and pointed to personal savings as the proper reserve against sudden disaster or ultimate destitution. Moreover, the higher wages paid in dangerous trades, or those in which employment was irregular, were regarded as a natural compensation for the greater risks incurred by the workers therein.

It has been found, however, that many workmen are financially unable to make sufficient provision for the event of serious accident, protracted illness, long unemployment, or old age. Indeed, the risks of industry are

often greatest among those groups which are least able to bear them. The result is a final resort to public relief or private charity in severe emergencies.

b. Cooperative and Corrective Character of Insurance. It is possible by relatively small but regular contributions from all healthy and employed workers to pay benefits to individual workers or their families in times of distress. This is the fundamental principle of insurance, namely, the removal of the financial incidence of some great loss from the particular individuals affected thereby and its diffusion throughout the entire group subject to that risk. Insurance, it will be remembered from Chap. V, substitutes periodic, small payments, called premiums, for a large but uncertain financial loss.

The very nature of insurance is cooperative, whether administered by public or private agencies. Social insurance, like business insurance, can convert insurable risks into calculable costs of production, most of which may be diffused through the group and eventually passed on to the ultimate consumer in price of product. But insurance should be corrective, as well as cooperative. Safe drivers are encouraged by a reduction in insurance premiums on their automobiles, and fire-resistant homes cost their owners lower premiums than inflammable houses. Similarly, the consuming public should pay less for the products of safe and stable conditions of employment than for those of dangerous trades and irregular occupations. This price differential among competitive products, which can be substituted for each other, would reward safety and encourage stabilization.

So far as pecuniary expenses approximate human costs, market prices are proportionate to social hazards, and products of better working conditions become cheaper and more salable, while those of a dangerous character become more expensive and are less widely consumed. The reverse situation, however, existed when safety and stabilization meant higher costs and higher prices, in contrast to the cheap products of firetraps and sweatshops. If property-insurance premiums can be regarded as legitimate costs of production, why should not social-insurance payments be viewed in the same light? Thus the worker bears the human risks, but passes the financial costs on to consumers. The greater the risk, the larger the insurance premium; the greater the cost, the higher the price of the product; the higher its price, the less sold.

c. Special Features of Social Insurance. Social insurance is the application of the basic principle of property insurance to the human risks of industry. It cannot compensate an individual for the loss of an arm, but it can recompense him for the loss of earning power which that involves. Social insurance represents compulsory, rather than optional, coverage of large groups of workers against the basic human risks of industry. Governmental regulation and supervision are even more necessary for the ad-

ministration of social insurance than for other types of insurance. On the other hand, social insurance does not necessarily involve the state in business. The state-fund form of administration can be employed, but it need not be used. Likewise, public subsidies are frequent but not essential features.

Because of the inability or reluctance of workers to insure themselves against the various risks of industry, the state has been forced to intervene. Governmental action has been justified not only for humanitarian reasons, but also because social insurance has been regarded as more economic than charity. Premiums come from the wages of the employees, from the profits of the employer, from the public treasury, or from a combination of two or more of these basic sources. If the worker makes some contribution, the plan may be called insurance. If it is freely provided by the state, it represents a pension or a dole, not insurance in the strict sense of the term.

In its final analysis, the essentials of a sound system of social insurance are: (1) complete coverage, (2) compulsory character, (3) cheap rates, (4) adequate and immediate benefits, (5) sound financial administration, (6) an actuarial basis, and (7) adequate reserves.

d. Types and Progress of Social Insurance. Workmen's compensation acts provide remuneration to victims of industrial accidents. As we shall soon see, they are a distinct advance over the older employers' liability laws. Most American states had such legislation before the First World War.

Dependent old age can be avoided either by old-age pensions, as originally in Great Britain, or by old-age insurance, as in Germany. The former is gratuitous, the latter contributory. Many American states had old-age pension laws before the passage of the Social Security Act of 1935, which extended them and which also introduced Federal old-age insurance.

Invalidity insurance applies the principle of compensation to the victims of nonindustrial accidents and sickness. It can be illustrated by pensions or subsidies to the blind.

The most controversial types of social insurance are those against unemployment and sickness, because of the lure of idleness on a dole and because of the ease of feigning sickness and the possibility of malingering. Great Britain is the chief industrial nation with longest experience with unemployment insurance. It was almost unknown in the United States until Wisconsin passed such a law in 1934. Unemployment compensation was basic in the Federal Social Security Act of 1935. Sickness insurance, providing both medical benefits and cash compensation, is common in Europe, but rare in the United States. Our program of Associated Hospital Service, known as the Blue Cross, was previously described. It does not include cash benefits; it does not even provide fees for physicians.

The theoretical fear of paternalism, on the one hand, and the practical danger of abuse, on the other hand, long militated against the extension in the United States of forms of social insurance other than that against industrial accidents. Mothers' pensions to dependent widows were provided by some states, but the limited appropriations available restricted their extension and limited their benefit.

30–23. Workmen's Compensation. Employers' liability laws permitted injured workers to recover damages by lawsuits against negligent employers. Court action was necessary and judicial decisions were uncertain. If the injury resulted from the contributory negligence of the worker himself or from that of a fellow servant, there was no redress. Lawyers, known as ambulance chasers, took only promising cases; they made huge charges for their services and court costs.

Workmen's compensation acts were an advance over the older employers' liability laws, because no court action became necessary, although it was still permissive. There was as great a change in political philosophy as in legal administration. Responsibility for the injury no longer remained a primary consideration. It became necessary merely to show that the worker had been hurt on the job. Most risks of industry were regarded as compensable. It was assumed that no worker would deliberately injure himself to collect compensation. Finally, rates were standardized by a formula involving the two factors of former earning capacity, as shown by previous wages, and reduced earning capacity, as shown by the severity of the injury or by the period of absence from work.

Almost all states now have workmen's compensation laws, but they vary greatly. Many have long waiting periods and limited benefits. In most states the payments are small and the coverage is restricted to accidents. Some workmen's compensation laws include occupational diseases, which are covered by comparable provisions. This is highly desirable, especially in the case of those occupational diseases that are specific. It is rare, however, in the case of general sickness, where the illness has little relation to the occupation. The cause of tuberculosis, for example, is dubious, while that of silicosis is definite. Coverage of occupational diseases may be a further step toward insurance against any type of sickness involving disqualification for work without regard to its cause as industrial in origin or general in character.

30–24. Social Security Act. In 1935, the Federal government enacted the Social Security Act, which was amended in 1939.

> The act was devised to provide some safeguard against the insecurity of modern life through cooperative action by the Federal and State governments, thus making possible fullest consideration of the local economic and social problems existing within States while maintaining a national unity of program and purpose.[1]

[1] Social Security Board, "A Brief Explanation of the Social Security Act," p. 1, *Circular* 1.

The act provided several distinct but related measures, including unemployment compensation, old-age assistance and old-age benefits, security for children, aid to the blind, extension of public-health services, and vocational rehabilitation.

a. Unemployment Compensation. The Social Security Act did not provide a national system of unemployment compensation. Instead it sought to stimulate individual states to provide such systems as might seem best for local conditions. It imposed a pay-roll tax of 1 per cent in 1936, 2 per cent in 1937, and 3 per cent in 1938 and thereafter, levied, with certain exceptions, on the pay rolls of all employers of 8 or more persons for 20 weeks a year. If the state has an unemployment-compensation law approved by the Social Security Board, contributions thereto are credited up to 90 per cent against the Federal pay-roll tax for this purpose. Hence, the incentive to states to pass satisfactory unemployment-compensation acts was their desire to keep within their own borders their own funds, demanded for this purpose by the Federal pay-roll tax. Immediately following the passage of the Social Security Act, all states prepared and passed unemployment-compensation laws.

Each state now has its own unemployment-compensation law. The chief unifying influences are the compulsion of the 3 per cent pay-roll tax paid by all large industries and the supervision of the Social Security Board, which must approve the law of a state if the latter is to receive its pay-roll tax refund. Some states require contributions from employees, which are in addition to, but not in lieu of, the 3 per cent mandatory pay-roll tax paid by employers. Some states have pooled reserves, which make no allowance for regularization of employment. Other states have rating systems that permit reduction in the unemployment pay-roll taxes on those industries which have built up substantial reserves, and that can show a record of regular employment. Benefits vary from state to state, but they approximate half pay. There are specified waiting periods before eligibility, to eliminate many minor and temporary layoffs. There are also payment limitations of a certain number of weeks after which the employee must find work or seek assistance. Qualifying and disqualifying features vary from state to state.

b. Old-age Assistance and Annuities. The Social Security Act set up two systems for aiding the aged, the one designed to subsidize states giving gratuitous assistance to needy individuals, sixty-five years of age or over; the other designed to provide annuities to persons at the age of sixty-five years on the basis of past wages received and pay-roll deductions made. The former encourages state pension systems of old-age relief; the latter provides a centralized Federal contractual and contributory form of old-age insurance.

Under the Social Security Act of 1935, the Federal government gave grants-in-aid up to $15 per recipient per month to those states that had ap-

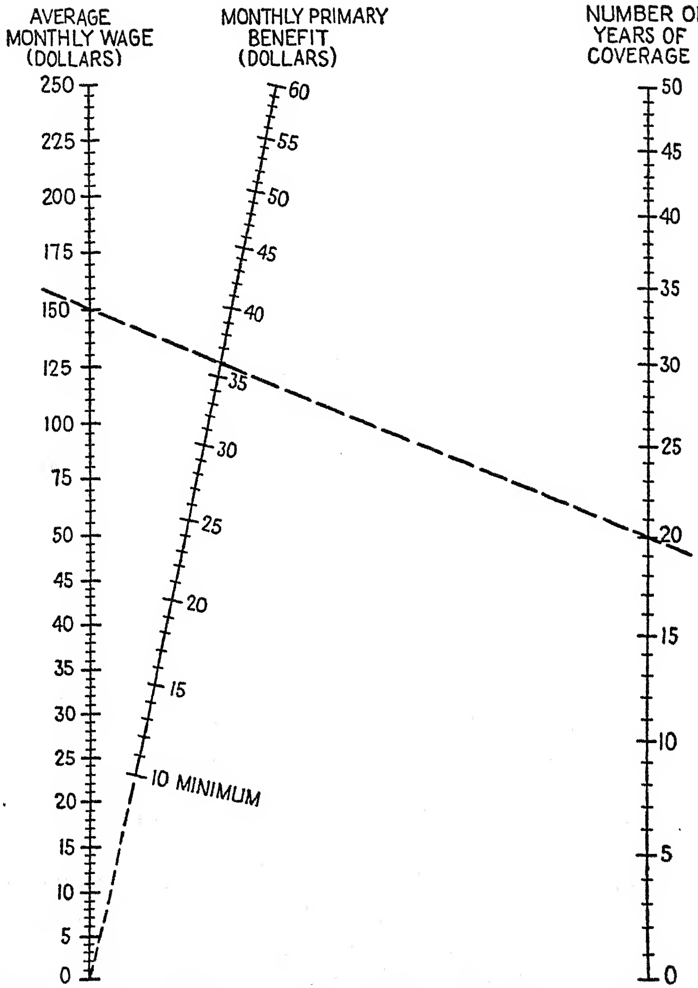

Chart 21. Social security benefits. This chart shows how much is due in monthly primary benefits when the number of years of coverage and the average monthly wage are known. In the example shown the employee averaged $150 a month for 20 years upon reaching the age of sixty-five. For those who in early 1937 earned $50 or more in the "quarter of coverage" in covered employment, coverage began Jan. 1, 1937. For others it began whenever $50 was earned in a quarter of coverage.
Assuming that the employee in the example earned $50 or more in the first quarter of 1937 and that he was forty-five then, he will become eligible in 1957, at sixty-five, for a monthly primary benefit of $36. This figure is taken from the diagonal line of the chart. Similar computations can be made by laying a straightedge across the chart from the figure representing the average monthly wage to that for the number of years covered at age sixty-five.
Primary benefits consist of the pension payments to the worker himself. Survivor benefits of 75 per cent of the primary benefits are payable to eligible widows and of 50 per cent to each eligible child, wife, or parent. The maximum total benefits payable are 200 per cent of the primary benefit or 80 per cent of the average monthly wage or $85 a month, whichever is least. The maximums do not apply to total benefits of $20 a month or less. The minimum total benefits payable are $10 a month. (*Chart prepared by the Central Hanover Bank & Trust Co.*)

proved old-age pension systems, provided the state matched or exceeded this amount. By amendment of 1939, Federal subsidy was raised to $20 for $20. It later became $10 of the first $15 and half of the next $30.

Old-age benefits under the annuity plan, operated exclusively by the Federal government, are paid as a right, not as a gift, to covered employees who have worked a certain number of quarters and earned a modest amount of wages therein. Benefits from a minimum of $10 a month to a maximum of $85 a month are computed as percentages of wages received and years worked. These annuities are financed out of taxes paid jointly by employers and employees to the Federal government, constituting for each group 1 per cent of wages up to $3,000 a year.

The Social Security Act of 1935 was amended in 1939. The joint payroll tax, instead of being increased as originally planned, was frozen at 1 per cent each on employers and employees. Despite this fact, benefits were greatly increased. Secondary benefits were added to the original primary benefits. The 65-year-old wife of a qualified worker received an additional one-half of his primary benefit. A similar amount is allowed for a child under eighteen, but total secondary benefits may not exceed the primary benefits.

Survivor benefits were included in the amendment of 1939. A widow, aged sixty-five, or a widow with a child, irrespective of her age, is entitled to two-thirds of the primary benefit. A parent over sixty-five years and/or a child under eighteen years receives half the primary benefit in the event of the death of a qualified worker. If there are no survivors eligible to receive secondary benefits, a lump sum of six times the primary monthly benefit is paid to the estate.

The computation of old-age benefits is explained in Chart 21.

c. Other Features. The Social Security Act made special provision for children through grants-in-aid to states to promote their programs of aid to mothers of dependent children, maternal and child-health services, health and educational services for crippled children, and child-welfare programs.

The act appropriated funds to stimulate states to furnish financial assistance to needy individuals who, although blind, seek to maintain financial independence outside special institutions. Federal aid for pensions to the blind was similar to that for old-age assistance. Originally $15 per month, for a like payment by a state, it was raised in 1939 to a $20–$20 basis. Later it became $10 of the first $15 and half of the next $30 of the pension.

The act appropriated Federal funds for aid to state and local health services. Encouragement was given to medical research, sanitation programs, control of contagious diseases, and health clinics. There is no provision for health insurance or payment of sickness benefits in the form of cash. A step in this direction, however, was taken by Rhode Island when it liberalized its unemployment benefits to cover absence because of illness.

The Social Security Act appropriated additional funds as grants-in-aid to states to extend and strengthen their programs of vocational rehabilitation of physically disabled persons, originally provided for by the Federal Vocational Rehabilitation Act. This work is under the administration of the United States Office of Education in the Department of the Interior.

d. Administration. The act established the Social Security Board, composed of three members, to be appointed by the President, by and with the advice and consent of the Senate, for a term of 6 years; not all three members may be of the same political party. This board is to approve, amend, or reject social security plans submitted by individual states wishing to qualify for grants-in-aid. It is to supervise the administration of approved and existing plans. Finally, it is to study social security programs throughout the world and to make appropriate recommendations for the improvement of plans in operation in the United States.

Guide Questions on Text

1. Show the social significance of industrial accidents.
2. What are some dangerous trades and why so?
3. Show the economic significance of ordinary sickness.
4. Compare workmen's compensation with employers' liability laws.
5. Define social insurance. What are its essentials?
6. Make out a case for compulsory sickness insurance in the United States or in your own state. Indicate objections.
7. What do you understand by "socialized medicine"? Is the expression good or bad? Why? Is the general idea sound? Why or why not? If so, how? If not, what then?
8. Outline methods of administering workmen's compensation.
9. Compare old-age insurance with old-age pensions.
10. Compare the relative necessity and difficulties of sickness insurance with those of unemployment compensation.
11. Define unemployment, differentiating the unemployed from the unemployable.
12. *a.* What is meant by the incidence of unemployment? How is it determined?
    b. Distinguish between unemployment as an acute problem and a chronic problem of industry.
13. Explain unemployment as a maladjustment in the demand for and the supply of labor.
14. Outline specific causes of unemployment in our industrial organization. Suggest remedies in each case.
15. Indicate causes and dangers of migratory labor.
16. Discuss public works as means of stabilizing employment.
17. *a.* Show how the Social Security Act brought about unemployment compensation.
    b. Indicate important ways in which state laws differ on it.
18. Explain carefully our two different ways of caring for the aged.

Topics for Investigation

1. Unemployment and the business cycle.
2. Dovetailing seasonal industries.

3. Invention of machinery and unemployment.
4. Fashion and unemployment.
5. Public employment bureaus.
6. Unemployment in Great Britain between the First and Second World Wars.
7. Reduction of mine accidents.
8. Reduction of traffic accidents.
9. Rehabilitation of industrial cripples.
10. Workmen's compensation law of your own state.
11. Unemployment compensation law of your own state.
12. Germany, a pioneer in social insurance.
13. Social insurance in Scandinavia.
14. Invalidity insurance.
15. Mothers' pensions.
16. Social insurance in Great Britain.
17. Beveridge Report on social insurance.
18. Full employment legislation and administration in the United States.

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Part Nine

LABOR PROBLEMS AND INDUSTRIAL RELATIONS

CHAPTER XXXI

GROWTH AND CONTROL OF LABOR ORGANIZATIONS

31–1. Types of Labor Organizations. Labor organizations are associations of workers for the purpose of improving their economic and social conditions. They may be classified either by their forms or by their functions. From the former point of view, there are four structural types of labor organizations: (1) labor unions, (2) trade unions, (3) industrial unions, and (4) company unions.

Labor unions, in the strict sense of that term, are of mere historical significance. The Knights of Labor may be taken as the best illustration of this type of organization. All classes of workers were welcomed into it; professional men and even employers were sometimes admitted. The labor-union movement was humanitarian and idealistic. Instead of the strike and boycott, reliance was placed on education, social reform, cooperation, and political activity.

The trade union is an association of workers in a particular craft. Its members are chiefly skilled workers. Although there may be federations of trade unions, each individual union preserves its own autonomy. Trade unionism is essentially utilitarian in its aims; it exists primarily to bargain collectively for improved conditions. Reliance is placed on the strike and other economic weapons. Most member organizations of the American Federation of Labor are trade or craft unions.

The industrial union cuts across craft lines. It seeks to unite all workers in an industry into a coherent and centrally controlled organization. Class consciousness and group solidarity are sought; the two extremes of narrow trade unionism and broad humanitarianism are avoided. Unskilled, as well as skilled, workers are admitted into industrial unions. The United Mine Workers have an industrial union. All workers in mines, irrespective of occupation or degree of skill, may become members of that organization. The Congress of Industrial Organizations is a powerful federation of industrial unions. The Industrial Workers of the World was formerly the chief industrial union.

Organizations of labor have been classified also as follows: (1) business unionism, (2) friendly or uplift unionism, (3) revolutionary unionism, and (4) predatory unionism.[1] It will be seen that the results of these two clas-

[1] Hoxie, R. F., "Trade Unionism in the United States," D. Appleton-Century Company, Inc., New York, 1920.

sifications are somewhat similar, even though the one is based on form of organization and the other on character or function.

Business unionism is another way of expressing the immediate and utilitarian objectives of trade unionism, such as increased wages for a particular group of workers. Friendly or uplift unionism is more general in its appeal and more idealistic in its aims. Its outstanding examples are labor unions in the strict sense of the term.

Revolutionary unionism, as illustrated by the Industrial Workers of the World, stresses class instead of craft consciousness. It calls on all workers to unite in an attempt to overthrow capitalism and to escape from the bondage of the wage system. Revolutionary unionists include syndicalists, who would establish an industrial commonwealth by direct action or by violence.

Predatory unionism may be regarded as business unionism conducted for the selfish interests and personal gains of its leaders. It has little regard for the welfare of rank-and-file members of the union or for the success of industry as a whole. Like the political machine in our cities, with which it may be associated, predatory unionism is corrupt and boss ridden; without definite aims, its course of action is expediency and opportunism. Predatory unionism has often been characterized by violence and terrorism. It has been termed a "racket."

Both these classifications omit company unions, which are associations of the workers of a particular plant or business concern. They follow the financial or corporate organization of the employer. Because they have been organized by management or have been subservient to it, company unions are not regarded by their critics as part of the labor movement. Although sometimes called independent unions because they are not affiliated with national unions, company unions in fact are often dependent on the employer.

31–2. Early Trade Unions in America. Colonial America was agricultural; the labor supply was augmented by slaves and indentured servants. Manufactures were relatively unimportant until the War of 1812, and large-scale industrialism was not established until after the Civil War. Before the advent of the factory system, however, craft organizations of skilled artisans had developed in our larger towns and cities. In the first quarter of the nineteenth century these organizations of labor became significant in our national life.

The modern trade union or association of allied craftsmen may be said to have originated in 1827 with the Mechanics' Union of Trade Associations in Philadelphia. Similar organizations were formed in other cities, and labor parties were organized in several states. A National Trades Union held its first annual convention in 1834. Carpenters, cordwainers, printers, and other skilled mechanics were represented by their respective national trade unions.

These early labor organizations expressed themselves vigorously against imprisonment for debt, convict labor, and sweatshops; they were favorably disposed toward the 10-hour day, free schools, and mechanics' lien laws. But the early trade-unionist movement in America soon lost its identity in the general humanitarian movements of the ante-bellum period. Abolitionists were interested in the elimination of slavery, and perfectionists were intrigued by cooperative communities. Disgruntled individuals and idealists went west to seek their fortunes in pioneer communities.

31–3. National Labor Union and Knights of Labor. The great industrial development which followed the Civil War stimulated the organization of labor on a vaster scale than ever before in America. Every large city had its trades' assembly composed of many organized crafts. The National Labor Union was formed in 1886; it held annual conventions for the following six years. Meanwhile the trade-union movement had been temporarily eclipsed by the rise of labor unionism.

The Noble Order of the Knights of Labor was founded by a tailor in Philadelphia on Thanksgiving Day, 1869. At first it was a secret organization with an elaborate ritual. This was abandoned when the movement spread from the garment workers to those of other trades. The Knights of Labor ceased to be a local organization as its ideal expanded into that of an amalgamation of all workers into one great labor union.

The original policy of the Knights of Labor was to discourage strikes and boycotts. It relied on educational and political action instead of these economic weapons. Through cooperative means and a campaign of education, it hoped to abolish the evils of the wage system and to substitute a cooperative commonwealth.

For a decade or two, the Knights of Labor was a powerful force in our national life, but its zenith was reached in 1886, when its membership amounted to almost 703,000 workers. The governmental machinery of the Knights of Labor was highly centralized; internal dissensions soon arose among local labor unions. Its membership and influence quickly waned.

31–4. American Federation of Labor. *a. Origin.* The American Federation of Labor was founded in 1881, but it was reorganized under its present name in 1886. It began as a reaction against the idealistic and centralized labor unionism of the Knights of Labor and as a revival of the more practical objectives and independent organization of trade unionism. The later disintegration of the once-powerful Knights of Labor discouraged political activity on the part of organized labor and encouraged reliance on its own weapons of collective bargaining.

At the time of its inception in 1881, the affiliated national unions of the AFL possessed a membership of only 40,000, but during the next 5 years this number more than tripled; at the time of its reorganization in 1886 the membership was 138,000; it rose to 260,000 in 1893; *i.e.*, it almost doubled.

The Knights of Labor failed to survive the depression of 1893. The AFL suffered merely a slight recession, from which it rapidly recovered to unchallenged leadership in the labor movement.

b. Its Development. The AFL increased from a membership of about 250,000 in 1897 to one of approximately 1.5 million in 1904. Trade-union membership as a whole meanwhile rose from 500,000 to 2 million. These 7 years, then, represented a period of vigorous growth for the AFL in particular, whose membership increased sixfold, and for trade unionism in general, whose membership quadrupled.

The following few years constituted a period of consolidation. From 1904 to 1909 membership in the AFL remained at about 1.5 million. Membership in all trade unions likewise fluctuated about its former mark of 2 million, with no definite upward or downward trend.

The years immediately before the First World War constituted a period of slow growth, halted by the incipient depression of 1914, which was reflected in the figures for 1915. Nevertheless, from 1909 to 1914, membership in the AFL increased to 2 million and that in all trade unions rose to 2.75 million.

The 5-year period of "war prosperity" from 1915 to 1920 was one of rapid growth, in which membership in the AFL doubled from 2 million to 4 million and that of all trade unions likewise doubled from 2.5 million to 5 million.

Retrogression followed expansion during the first postwar depression. From 1920 to 1923 membership in the AFL fell by 1 million and that of all trade unions by 1.5 million. The movement sloughed off much of the mushroom growth of the earlier period. Nevertheless, it remained larger and stronger than it had been before the First World War.

The period of economic prosperity between the minor depression of 1921 and the major depression following 1929 witnessed the rapid spread of company unionism. With this new rival in the field, the growth of trade unionism was arrested; for the first time in its history, membership figures did not expand in the prosperity phase of the business cycle. Although there were minor fluctuations between 1923 and 1929, there was neither net growth nor decline. Membership in the AFL remained at about 3 million and that in all trade unions at about 3.5 million.

The great depression took a terrible toll from labor organizations, striking evidence of which was the decline in union dues. Although not so evident in the first year or two, the drop in membership was especially severe in 1932 and 1933, by which time the rolls of the AFL were down to their prewar level of approximately 2 million and those of all trade unions were reduced to about 3 million.

Following the legalization of collective bargaining in 1933 and 1935, membership in the AFL increased rapidly. Despite the rupture with the

CIO and the business recession of 1937, the AFL in 1940 passed its previous peak of 1920. At the time of our entrance into the Second World War, it had a membership of over 4 million; at the end of the war it emerged with about 6 million members.

c. Organization of American Federation of Labor. The AFL is a loose affiliation of about one hundred national and international trade unions. Relationships are complex and changing. Variety and variation of organization are the rule. The individual union is autonomous and jealous of its freedom of action.

Samuel Gompers, former president of the AFL, defined it in the following statement which is still an accurate description of its organization.

> The American Federation of Labor is a federation of organizations, each of which has its own government, determined by its own needs and requirements, the result of the experiences of the members of the organization. The right to self-government was recognized in the beginning and has been reaffirmed and adhered to as consistently as possible. The federation has no powers except those which are authorized and conceded by the organizations which compose it. These powers are enumerated in its written constitution and in the definite direction of the convention.[1]

The local trade union is to the AFL what the cell is to a biological organism, for it is the basic unit of the entire trade-union organization. With this nucleus, the process of expansion may be vertical, horizontal, or both. The locals are required to join the national unions of their respective trades. Sometimes there are also state and international trade unions. At the same time, a local trade union may affiliate itself with the central labor union of the town or city in which it is located. In such a case the combination is termed a "federal trade local." Where the workers in any one craft are too few in numbers to form a local for any one particular trade, they may ignore craft lines and organize as a federal labor union.

The national or international trade union is an important unit, for sovereignty lies in the individual union, rather than in the federation as a whole. Strong national trade unions maintain experienced organizers and create their own locals, to which they may issue charters. National unions can render financial assistance to struggling locals, but they can also discipline them for going against their general policy and that of the AFL.

The annual convention of the AFL is important. Officers are elected, problems are discussed, and policies are formulated. Each national trade union is represented by one delegate for each 4,000 paid-up members or fraction thereof. One delegate each is allowed state federations, city centrals, federal labor unions, and federal trade locals. Several fraternal

[1] GOMPERS, S., "Labor and the Employer," chap. 1, E. P. Dutton & Co., New York, 1920.

organizations also are represented. An executive council, consisting of a president, numerous vice-presidents, a secretary, and a treasurer, is elected annually. It carries on the work of the AFL from one annual convention to another. Permanent headquarters are maintained in Washington from the revenue derived from a per capita assessment on the membership of the affiliated unions.

31–5. Independent Unions. The AFL is not all of the general trade-unionist movement of this country, although numerically the most important part. Trade unionism includes some important but independent craft unions not affiliated with the AFL. The Railroad Brotherhoods, for example, are independent trade unions.

The reverse also is true. The AFL includes a few unions that are industrial in character and not organized along trade-union lines. The United Mine Workers of America is the outstanding illustration of an industrial union formerly affiliated with the AFL. It seceded, helped to form the CIO, from which it later became independent, then returned to the AFL, and, finally, again disaffiliated.

Fluctuations in the composition of the AFL, due to the formation of new affiliations or the disruption of old ones, are frequent. Hence the strength of the trade-unionist movement in this country cannot be inferred merely from membership figures of the AFL. Total trade-union membership, as just indicated, has been about 25 per cent greater than that of the AFL. There are now over a million trade unionists not directly affiliated with the American Federation of Labor. When not involved in jurisdictional disputes, their officials work cooperatively in general labor policies.

31–6. Syndicalism and Industrial Workers of the World. *a. Origin.* The organization known as the Industrial Workers of the World emerged in 1905 at Chicago as a merger of such radical groups as the Socialist Labor Party, the American Labor Union, and the Western Federation of Miners.[1] In 1908, differences developed as to the course of action, and the Industrial Workers of the World split into two groups which were known as the Chicago and the Detroit branches. In 1915, the latter became known as the Workers' International Industrial Union. This group had socialism as its objective and favored political, as well as industrial, action. Hence it might be classified as a radical type of socialism. The Industrial Workers of the World, *i.e.*, the Chicago branch after the secession of the Detroit branch, was syndicalistic rather than socialistic.

The French word *syndicat* means "union." Syndics were really councils of communists. The Industrial Workers of the World in America, syndicalism in France, revolutionary industrial unionism in Great Britain, and Bolshevism in Russia were different national aspects of a general world movement. Private property and the political state were condemned.

[1] This organization later withdrew and joined the AFL.

b. Aims. The Industrial Workers of the World was an industrial, not a trade, union. Its aims and practices, as well as its organization, afforded a striking contrast to the more conservative AFL. The IWW represented revolutionary, not evolutionary, unionism. Bitterly opposed to the utilitarian aims and conservative methods of trade unionism, the promoters of this labor organization sought amalgamation into one big union. Whereas the AFL accepted capitalism and the state, the IWW sought the destruction of existing economic and political orders.

The IWW repudiated political action on the one hand, and collective bargaining on the other. Direct industrial action by all workers through the general strike was advocated. The doctrines of class struggle and revolution were taught; the solidarity of all workers was sought for the dictatorship of the proletariat.

c. Policy of Sabotage. Direct industrial action includes not only the general strike, but also sabotage. The origin of this term is found in the French word *sabot*, meaning the rough wooden shoe worn by European workers. The American expression of "dropping a wrench in the works" is its equivalent. If the demands of the workers are not met, they may secretly destroy the machinery of their employer. It is almost impossible to discover the malefactor without resort to industrial espionage. It is obvious that sabotage, if unchecked, can cause tremendous human and property losses. On the other hand, sabotage may be merely the peaceful "soldiering on the job," represented by the "slow-down" strike.

d. Strength. Because of its radical aims and violent methods, the Industrial Workers of the World was a hated and hunted organization. Although a serious threat to industrial production and the existing economic order, its membership was relatively small and unstable. In 1910, the first year for which information was available, the secretary-treasurer of the organization announced 5,863 paid-up members. By 1917, this had increased to about 60,000, and an aggregate of 300,000 membership cards had been issued since the beginning of the organization in 1905.

During the First World War, a vigorous policy of suppression was carried on by the government. Whether the result was an increase or a decrease in membership of the IWW is difficult to determine. A policy of secrecy was adopted and a resort to underground methods of activity was made. Even in peaceful and normal times it was difficult to get authoritative figures for the membership of the IWW, which attracted a variable and an unsteady group, composed largely of floaters and casual workers. During the depression of 1929 to 1933, the IWW almost disappeared. A convention was held in 1931, but only seven official delegates were present.

31–7. Communists in Unions. Although the IWW is an organization of mere historical interest, revolutionary unionism has not disappeared from the American labor movement. Nor has the practice of sabotage

been discarded entirely, or even disclaimed completely. There has been considerable "boring from within" unions by communist "fifth columns," as well as predatory activities known as "racketeering" by unscrupulous leaders and irresponsible unions. The communist element is now playing a role in labor affairs somewhat similar to that formerly enacted by the syndicalistic IWW.

A few unions have been communist controlled, and many of them have had, and, in fact, still have strong communist minorities. Examples are the maritime and waterfront unions, torn by jurisdictional disputes, and featured by violence and rackets. Obviously, communists do not accept the capitalistic system but openly or secretly seek the overthrow of the present economic order, as did the former IWW. The more constructive and conservative unions in the AFL were continually conducting crusades against the communists in their midst. The Taft-Hartley Labor-Management Relations Act of 1947 proscribed communists from union leadership by requiring the filing of a loyalty test.

Before Hitler's attack on Russia the communists opposed America's involvement in European war. When the United States and Russia became allies in the Second World War, the communists were insistent that a second front be opened promptly in Europe. As they loyally supported this "People's War," which somehow was no longer a capitalistic war, there was little sabotage of industrial production.

After the Second World War, the united front of communists and socialists with capitalists against Fascism and Nazism broke down. Communists again sought to capture control of radical unions by promoting industrial division and disorder. They became even more active politically, favoring "cooperation" with Russia. Even the CIO established a Committee for Political Action. There was some discussion of the formation of a third party, to be called perhaps a Labor Party, but definitely under control of left-wing elements. American relations with the Soviet Union will be discussed in our final chapter.

31–8. Congress of Industrial Organizations. *a. Background.* Industrial unionism had existed in the United States before the New Deal; the outstanding example was the Industrial Workers of the World. Even within the ranks of the more conservative AFL there were some unions organized vertically on an industrial basis, instead of horizontally on a craft basis; the most conspicuous illustration was the United Mine Workers.

The increased mechanization of industry, the growth of big business and large corporations, and the advent of mass production led many labor leaders to feel that industrial unionism was better adapted to modern production methods than was the older trade unionism. Moreover, the failure of trade unions to expand during the prosperous twenties and to resist successfully the gains of company unions seem to confirm their views. Finally,

the legalization of collective bargaining in 1933, and again in 1935, offered an unprecedented opportunity to organize basic industries, such as motors, steel, and textiles, and to reach the great groups of semiskilled machine operators. The unionization of these mass-production industries and the organization of thousands of workers on repetitive jobs apparently could not be done effectively on a craft basis. A different and more successful approach by the industry as a whole could not or would not be taken, so it was felt, by the AFL under its existing leadership and under its traditional form of organization.

b. Origin of Congress of Industrial Organizations. Although trade unions increased in membership after the New Deal legislation, industrial unions grew relatively more rapidly; they likewise sought new fields of conquest. The AFL, however, was reluctant to grant industrial charters to existing or new unions in the automotive and other mass-production industries. It resisted such forms of organization; it recognized the paper claims of older, smaller, and less active trade unions; it sought to mold new unions along the traditional lines of craft organization into small, specialized unions of an outmoded character.

These issues had been discussed at length in committees and conventions of the AFL. The "old guard" refused to shift its position; it held tenaciously its strongly entrenched inner citadel. The 1935 Convention of the AFL was featured by bitter contests of words and fists; it displayed slight alteration of attitude and produced little change of policy. Consequently, a self-appointed Committee for Industrial Organization got together in Washington later that same year. It originally consisted of eight members, who were bitterly disappointed at the failure of the AFL to embrace industrial unionism and who were prepared to "go it alone" with their own industrial unions as a nucleus. Conspicuous among these leaders of the new labor movement were John L. Lewis of the United Mine Workers, Sidney Hillman of the Amalgamated Clothing Workers, and David Dubinsky of the International Ladies' Garment Workers. Subsequently, Mr. Lewis became President of the CIO, but he was succeeded by Philip Murray, President of the United Steel Workers.

Great success promptly attended the efforts of the Committee for Industrial Organization. Thousands of workers, many of them hitherto unorganized, in steel mills, textile plants, and other large industries formed active unions and affiliated with the new organization. These successes of the CIO embittered the AFL but failed to change its policy. This dualism within the American labor movement did not heal; it broke into an open rupture one year after its first appearance.

The great schism is commonly dated 1936, because in that year the Executive Council of the AFL suspended most of the original members of the CIO. Instead of impeding its future progress, however, this action

seemed to stimulate the further and faster growth of the suspended organization. Before the end of the next year, 1937, there were over thirty important national unions affiliated with the CIO, which even then claimed a membership of over 3 million. With the achievement of independence and the prospect of permanent status, the Committee on Industrial Organization became the Congress of Industrial Organizations. The number of members and of affiliated unions continued to grow. Membership figures rose to over 5 million and rivaled those of the AFL. Unions affiliated with the CIO are fewer but larger than those of the AFL.

c. Organization of the Congress of Industrial Organization. The structure of the CIO is dissimilar to that of the AFL in that the CIO is organized vertically into larger but more heterogeneous units on an industrial basis, whereas the AFL is organized horizontally into smaller but more homogeneous units on a craft basis. On the other hand, the CIO is similar to the AFL in that each is a loose confederation of semi-independent and sovereign national unions. Because an industry is larger than a craft, there are only forty some constituent unions of the CIO, in contrast to over a hundred constituent unions of the AFL, despite the fact that individual membership in the two organizations is approximately the same. The Executive Board of the CIO, like the Executive Council of the AFL, manages routine business between annual conventions; it controls union councils or federations and local industrial unions, subject to the general policies laid down by the convention, to which appeal can be made.

Affiliations in the new organization, like those in the older body, are tenuous and temporary. The composition and character of both organizations are constantly shifting. New unions may be added, and member unions may secede. Several unions left the AFL for the CIO after the signal success of the latter organization, but some returned later. Hence, it is difficult to give up-to-date, accurate membership figures.

d. Policies. The activities of the CIO differ somewhat from those of the AFL, just as their general attitudes and their specific constitutional provisions are at variance with each other. The CIO has been more dynamic and experimental than the AFL, which has been relatively more stable and conservative. For example, sit-down strikes were espoused by some industrial unions but eschewed by most craft unions. Their most conspicuous use was in 1937 by the automobile workers in and around Detroit, most of whom had recently been organized on an industrial basis within the ranks of the CIO. Some of these workers subsequently replaced the sit-down strike by the slow-down strike. But even conservative trade unionists advocate restricting production as a counterweapon against speeding up workers.

It is true, in general, that the CIO is more radical or progressive than the AFL. It is not accurate, however, to call it a revolutionary organization

or to regard it as similar to the IWW. The CIO accepts the present economic system and does not seek the overthrow of capitalism or the destruction of our representative form of government. It has sought to check the boring from within of Communist elements within its ranks. Like the AFL, the objectives of the CIO are higher wages, shorter hours, and better working conditions. Unlike the AFL, however, it has adopted a broader form of organization; it has conducted a more vigorous campaign of organization; it has gone into the mass-production industries; it has accepted the unskilled and the semiskilled workers; and, finally, it has utilized new weapons of collective bargaining.

e. Rivalry of Unions. The AFL and the CIO are both complementary and competitive. In general, they have worked in different ways in different areas. Nevertheless, they have overlapped in organization and conflicted in policy. The CIO has not confined its organizational efforts to industrial unions; it has accepted some craft unions whose relationships to the AFL were natural but unhappy. Moreover, not all member unions of the AFL have been conservative in their policies. Rackets have existed and coercion has been exerted among some of the less respectable unions of this older and more traditional labor organization. Although some CIO unions also have been reckless and irresponsible, the trade agreements of many CIO unions have been honestly negotiated and faithfully kept.

In short, all generalizations are dangerous beyond the obvious observation that the labor movement, like almost all social and political developments, has been opportunistic and particularistic. Policies have varied from time to time and from place to place. There has been neither unity nor consistency within the labor movement. There is the present schism between the AFL and CIO, which increased in bitterness with the years following the suspension or secession. Outlaw strikes have been frequent within both organizations.

Since the open break in 1936 the general policy of each body has been one of "catch as catch can." In some occupations there are two rival unions, one affiliated with the AFL and the other with the CIO. The maritime industry was a notorious example. The CIO has local industrial unions among truck drivers, printers, and hotel employees, despite the fact that the AFL has national unions in these same occupations. Feuds have been frequent, not only between the AFL and the CIO, but also between their constituent unions about lines of jurisdiction and between local and national unions about claims of authority. Personal animosities among the men who lead labor have weakened the general movement and increased the disunity. The interunion battle between William Green, President of the AFL, and John L. Lewis, President of the CIO, was followed by that between Mr. Lewis of the United Mine Workers and Mr. Murray of the United Steel Workers, who replaced him as president of the CIO.

31–9. Bird's-eye View of American Labor Movement. In reviewing the history of American labor organizations, four stages are discernible. The first step was the development of trade unions among craftsmen in our Eastern cities. They held small but significant conventions in the late 1820's and early 1830's.

The second and more spectacular stage was in 1886, when the combined membership in both Knights of Labor and the AFL almost reached the million mark. As the great majority of these organized workers belonged to the Knights of Labor, the year 1886 represented the peak of labor unionism.

The third point, later and higher, was that of 1920; it represented the pinnacle of trade unionism. In that year, membership in the AFL was over 4 million and that in all trade unions was over 5 million. Trade unionism then stood almost without a rival, for labor unionism of the Knights of Labor had passed into history, industrial unionism of the IWW was being suppressed, and company unionism of employees was in its infancy.

The fourth step, which is the latest and highest in the entire history of organized labor in this country, can be dated from the passage of the National Industrial Recovery Act of 1933, which was declared unconstitutional, or from the National Labor Relations Act of 1935, which was sustained by the Supreme Court. As this law reaffirmed the principle of collective bargaining and set up administrative machinery for its enforcement, it was stimulating to trade unions but depressing to company unions. It was, as we have seen, reviving to industrial unions. Within a decade after its passage union membership as a whole quadrupled from 3 to 12 million.

31–10. Status of Collective Bargaining in the United States. Although American trade unions were not forced to go through such a severe struggle for existence as did the first English trade unions, their legal freedom and economic power were achieved later here than in the mother country. Exemption of members from liability for acts of union officers and sympathizers also was a slower development in this country.

At the present time, the right of unions to exist in the United States is not denied, but in certain states labor organizations that are committed to syndicalism are illegal in themselves. Although the privilege of collective bargaining is not denied, certain weapons of collective bargaining have been outlawed in many American states. Federal recognition of the principle of collective bargaining, as just stated, was secured in the National Industrial Recovery Act of 1933 and the National Labor Relations Act of 1935.

In this country, collective bargaining has been restricted by constitutional as well as by statutory law. The doctrine of judicial review has meant that the courts can declare some legislation unconstitutional. Many

labor laws have been held to be violations of such constitutional guaranties as that of freedom of contract, held by the courts to be implicit in the property right guaranteed under the Fifth and Fourteenth Amendments.

Much labor legislation falls within the residual powers of the individual states. Hence laws concerning the rights and powers of collective bargaining vary from state to state. This lack of uniformity is further complicated by the variety of court decisions in different states. The Federal character of our American government, as well as its constitutional nature, has served to confuse the general status of collective bargaining in this country. It will be seen that some practices of labor organizations are legal in some states but illegal in others, as well as valid at one time and invalid at another. The expansion by the United States Supreme Court of the concept of interstate commerce to include intrastate industry has increased the sphere of Federal control over unions as well as over corporations.

The old common-law doctrine of conspiracy formerly limited the activities of unions. But it is now generally legal for a group of individuals to do that which is legal for individuals themselves to do. The charge of conspiracy was supplanted by that of illegal combination in restraint of trade, as defined in antitrust statutes. Let us now see how these laws, discussed in detail in the preceding part of this text, were applied to unions.

31–11. Sherman Act and Clayton Act. Although trade unions themselves have not been regarded as combinations in restraint of trade, many practices of collective bargaining have been viewed as unwarranted interferences with interstate commerce and as combinations in restraint of trade. Thus the boycott maintained by the Danbury Hatters was held by the United States Supreme Court to violate the Sherman Act. Under the provisions of this law, triple damages of about $300,000 were awarded to the Loewe Hat Company.[1] Members of that union were held individually liable if they continued their membership.

The Clayton Act was heralded as the American magna charta of labor, because it proclaimed that "the labor of a human being is not an article of commerce." [2]

In addition to this general denial of a commodity theory of labor, the Clayton Act specifically provided that the antitrust laws do not forbid the existence of labor organizations or restrain their members from carrying out "legitimate objectives." But the Sherman Act never had been interpreted as a denial of the right of labor organizations to exist, even though it had been construed to restrict certain weapons of collective bargaining. This legalization of objectives, which were already legitimate, was as unnecessary as the declaration of the human character of labor was obvious.

[1] *Loewe v. Lawler*, 208 U.S. 274 (1908).

[2] Sec. 6 of the Clayton Act.

The Clayton Act, however, did seek to remedy some weaknesses of collective bargaining under the Sherman Act. It sought particularly to strengthen labor's weapon of the boycott and to lessen management's use of the injunction. But, as will be shown later, the high hopes of labor leaders were not realized in either of these two respects. The Clayton Act failed to clarify the legal status of labor organizations and to strengthen their weapons of collective bargaining. Nevertheless, this law was not potentially antiunion in character as was the Sherman Act.

31–12. Norris–La Guardia Act. Such court decisions as that rendered in the Danbury Hatters case were bitterly criticized by labor leaders and liberal statesmen. After years of popular agitation, the Norris–La Guardia Act was passed by Congress in 1932. Section 4 of this act, which sought to curb abuses of injunctions in labor disputes, will be treated later. Section 5, which denied conspiracy, and Sec. 6, which limited liability, will be outlined here.

The Norris–La Guardia Act attacked the old common-law principle of conspiracy that held that an act, lawful when done by one person, might be unlawful when done collectively. It affirmed the long-accepted British principle that no person engaged in a labor dispute should be judged guilty of conspiracy merely because of collective action.

This law also disavowed blanket responsibility, such as was implied in the Danbury Hatters decision. It provided that no Federal court should hold any union agent, officer, or member liable for unlawful acts committed in the course of a labor dispute "except upon clear proof of actual authorization, participation or ratification of such act." Such a position also is in line with the long-accepted principle of British law. It puts the burden of proof on the accuser and not on the accused. It makes necessary the apprehension of the individual criminal or criminals and does not diffuse responsibility over an entire organization.

The passage of the Norris–La Guardia Act was hailed as another great victory of labor and as another decisive triumph of human rights over property interests. Early court decisions, however, were discouraging; they limited the coverage of the Norris–La Guardia Act to interstate commerce. Consequently, individual states found it necessary to pass their own state laws similar in aim and content to the Norris–La Guardia Act. The expansion of the concept of interstate commerce, however, changed this situation.

31–13. Collective Bargaining under the National Industrial Recovery Act. *a. Background.* Business interests formerly had been favored by the law and by the courts. The workers, less powerful economically, had also been less fortunate politically. And all this despite the oft-repeated assertion that labor is not a commodity, and despite the frequent contention that high wages are not to be viewed with the same apprehension as high prices.

The years of depression following 1929 were those of economic distress, social unrest, and political panaceas. They were followed by years of relief, recovery, and reform, the new three R's of Franklin D. Roosevelt, who appealed at the polls to the masses of "forgotten men" and who, in his campaign speeches, repudiated the "princes of privilege." The New Deal was, in effect, an economic revolution; *i.e.*, it turned things about. It sought to extend the more abundant life to the underprivileged; it likewise sought to redress the balance of power between employers and employees by recognizing and fostering the right of workers to bargain collectively. Big business went under a cloud of public criticism; labor moved from the shadows to the sunshine of political favor.

b. Legalization of Collective Bargaining. The National Industrial Recovery Act of 1933 affirmed the right of labor "to organize and bargain collectively through representatives of their own choosing." The framers of this law regarded the organization of workers into effective and independent groups as desirable as the organization of employers into trade associations. The former were to bargain collectively as to wages, hours, and working conditions; the latter were to formulate industrial codes concerning trade policies and practices.

Labor leaders hailed this legal sanction of collective bargaining as another magna charta of labor. John L. Lewis, President of the United Mine Workers of America, called it the greatest advance in the legal status of labor since Lincoln's Emancipation Proclamation.

c. Interpretations. Labor leaders attempted to interpret the legalization of the general principle of collective bargaining by the National Industrial Recovery Act as a vindication of the closed shop, walking delegate, and other forms of collective bargaining, to be discussed more fully in the following chapter. As just demonstrated, they succeeded in capitalizing this gain in the legal status of labor by an intensive campaign for increased membership in their own unions.

On the other hand, employers contended that company unions, or associations of their own employees, were organizations practicing collective bargaining within the meaning of this law. Indeed, some sought to write such an interpretation of the general principle into their own industrial codes. These attempts were unsuccessful. Equally fruitless were efforts of labor organizations to secure legislation that would completely outlaw company unions. Meanwhile it was necessary for government officers to supervise elections in order to determine whether or not coercion had been exerted, and which of several rival organizations was the real choice of the majority of the workers concerned. In some cases it was necessary to deal with two or more organizations within the same plant.

Controversy over the interpretation of the general principle of collective bargaining and contention among rival labor organizations for the coveted position of the workers' choice were abruptly halted by the important de-

cision of the United States Supreme Court in 1935 declaring unconstitutional the National Industrial Recovery Act.

31–14. National Labor Relations Act. The decision of the United States Supreme Court invalidating the National Industrial Recovery Act repudiated the previous legalization of the general principle of collective bargaining and the industrial codes formulated under it. If this principle was to be saved and perpetuated, prompt action and new legislation were needed. Accordingly, the National Labor Relations Act, known popularly as the Wagner Act, was passed hurriedly the same year that the National Industrial Recovery Act was declared unconstitutional (1935). The new law, like its predecessor, was based on the interstate commerce powers of the Federal government; but it avoided the previous mistake of delegating legislative power to the executive branch of government, and so withstood successfully the charge of unconstitutionality.

a. Provisions. The National Labor Relations Act reaffirmed the general principle contained in the National Industrial Recovery Act; it guaranteed to workers the right to bargain collectively through representatives of their own choosing. Moreover, the principle of majority rule developed. The employer must recognize and negotiate with whatever union the majority of workers in his plant designate. This made it difficult for him to foster rival unions and to play one union off against another.

The law legalized the union shop, but it did not enforce the closed shop. It compelled the employer to treat with whatever union the workers chose, whenever the majority of them so decided. But the law did not compel every worker in any such industry to join that union or even to join any union; nor did it force the employer to hire and to retain only union men, even though he could not discharge a man for union membership or organization activity. It did not require the check-off, under which the employer deducts union dues from the wages of his men and then turns these funds over to the union officers. Trade agreements containing such provisions, however, were not invalidated.

The law did not require the arbitration of industrial disputes; nor did it deny the right of labor to strike. The purpose of this act was to preserve the right of collective bargaining and not to promote industrial conciliation, a desirable aim that has been expressed in other laws and exercised through different agencies.

b. Prohibitions on Employers. In addition to the promotion of the general principle of collective bargaining, the National Labor Relations Act contained a set of specific prohibitions of things that the employer might not do. These "don'ts" may be grouped roughly about the three D's of *domination, discrimination,* and *discharge.* The employer might not interfere in the internal affairs of a labor organization, nor might he contribute financially toward its support. The employer might not discrim-

inate between union and nonunion men or between members of rival unions in his hiring and firing; nor might he discharge a worker because of union activity or because he filed charges or gave testimony against an employer. The law proscribed interference, coercion, or restraint of employees by employers, just as it prescribed that the employer must bargain collectively with the accredited representatives of the majority of his workers; these prohibitions were regarded as essential to the fundamental principle of collective bargaining.

c. Administration. Finally, the law created an administrative agency to supervise current practices of collective bargaining, to investigate charges of workers against employers of discrimination or coercion, and to conduct plant elections. This agency, known as the National Labor Relations Board, consisted originally of three members appointed for 5-year terms by the President of the United States with the approval of the Senate.

The National Labor Relations Board established regional offices to hear cases of alleged discrimination or coercion within their respective jurisdictions. An employee might report directly, but he generally preferred to bring charges through the union of which he was a member. The director of the regional office then ordered a field investigator to explore the situation and to discover whether or not there was sufficient cause to order a trial hearing. If the charge was grave and the evidence seemed sufficient, the employer was summoned to the regional office and there given an opportunity to refute the indictment. Were the charge of intimidation, discrimination, or coercion sustained, the regional director ordinarily issued a "cease and desist" order; he might also penalize the employer judged guilty and order the reemployment of the worker or workers unfairly discharged, with perhaps payment of back wages.

d. Criticism. Employers bitterly criticized the National Labor Relations Act because it interfered with their former right to hire and fire as they chose. They contended that the act was one-sided in that it favored unions, but hampered employers. This criticism was true but exaggerated. The law was specifically intended to balance the disparity between the economic powers of the two parties by granting to workers the legal right to bargain collectively through representatives of their own choosing and by enforcing that right through legislative prohibitions and administrative procedures.

When an attempt is made to redress a wrong or to right a disequilibrium, the result is often to throw the scales of justice from one side to the other. Such apparently was the case with labor relations in general and with the National Labor Relations Act in particular. The disparity remained, but in reverse and to a lesser degree.

Opposition was expressed to the tremendous power vested in the National Labor Relations Board. Considerable dissatisfaction resulted from

"unfair" methods of procedure and from delays in the disposition of cases. Employers claimed that decisions were biased in favor of labor, and that management was often convicted in advance without judicial trial and without adequate opportunity to present its own evidence.

Many other criticisms might be made of particular parts of the National Labor Relations Act and of specific features of its administrative procedure. But more important than the petty sins of commission were the great sins of omission. Intimidation and coercion of employees by employers were forbidden by law, and properly so. But intimidation of workers by other workers and coercion of unorganized employees by organized employees were equally vicious and even more common. The law was silent, however, on this point, which might well have been covered by supplementary legislation. Again, if an employer was forbidden to aid a union and to interfere in union affairs, by what right could union leaders ask employers to perform the check-off service, to collect union dues, and to maintain union membership?

e. Similar State Laws. The Federal government has power over interstate commerce, but individual states possess jurisdiction over intrastate industry. Hence the legalization of labor's right to collective bargaining requires state, as well as Federal, action. Consequently and subsequently, certain states passed laws similar in purpose and procedure to the National Labor Relations Act. It will be remembered that the Norris–La Guardia Act was likewise supplemented by similar state laws. In this way our national order worked slowly but voluntarily toward a more uniform pattern of social and economic legislation. In contrast, the Social Security Act of 1935 moved us rapidly but coercively toward the desirable goal of legislative action by states by the impulsion of Federal subsidies and the compulsion of a Federal pay-roll tax to be returned to cooperating states.

31–15. Labor-Management Relations Act. Employers' criticisms of the National Labor Relations Act, such as we have just outlined, received little consideration for a decade. But the postwar epidemic of industrial disputes, particularly the 1946 strike of the coal miners against the national government, finally aroused public opinion, which found expression at the polls. The Taft-Hartley Act of 1947, passed by Congress over the veto of President Truman, amended the Wagner Act by making important changes in the status of unions and in the practices of collective bargaining.

a. Provisions Immediately Effective. The following features became effective on June 23, 1947, the date of passage of the law.

The United States government can require a *postponement for 80 days of strikes or lockouts* endangering the national health and safety. Meanwhile negotiation, mediation, or investigation will continue. This provision merely postpones strikes in basic industries, which become legal after this interval unless legislated otherwise. If no mutually satisfactory agreement

is reached during this "cooling-off period," the industrial issue is referred to the President for subsequent report and recommendation to Congress. Although no individual can be compelled to work against his will, organized activities, such as picketing and payment of strike benefits, are prohibited during the 80-day postponement period, during which time existing industrial conditions are frozen *in statu quo.* Enforcement of this provision by court injunction is possible.

Employers can sue unions for *breach of contract.* Employers and other injured parties also can sue for damages resulting from *jurisdictional strikes* and *secondary boycotts* conducted by unions.

The *check-off* is permissible if mutually agreed to by union and management, but the individual worker must authorize such pay-roll deduction of his union dues. Provisions of existing agreements, however, are not invalidated.

Unions cannot spend money or make *contributions* to the political campaigns of the President and members of Congress.

Welfare funds can be established only if the agreement to do so specifies that payments therefrom are to be limited to death, sickness, accident, retirement, medical, and unemployment benefits. If employers contribute to such welfare funds, they must be granted participation in their administration. Welfare funds established before Jan. 1, 1946, are exempt from this provision.

Federal workers who strike are to be discharged with forfeit of their civil service status and with ineligibility for reemployment for three years.

b. Subsequent Features. The following provisions became effective 60 days after passage, *i.e.*, on Aug. 22, 1947.

The *closed shop* requiring employers to hire only union members is prohibited. The *union shop,* under which the employer can hire whom he pleases, but under which all new employees must join the union within 30 days, is permitted. Not only must the employer agree to the union shop, but it must also be favored by a majority of the employees eligible to vote in a NLRB election. The same is true of *maintenance of membership,* under which workers who join the union must retain their membership or quit their jobs. But under the union shop the employer does not discharge a nonunion employee who has been denied membership in that union. Provisions of existing agreements remain effective until they expire. This Federal statute does not legalize the union shop in those states which have forbidden it.

Supervisory employees having the power to hire, fire, promote, transfer, suspend, reward, or discipline other employees are excluded from the guaranteed collective bargaining rights of the Wagner Act. Unions of foremen are not outlawed, but the employer is not compelled to recognize them or to bargain collectively with them, as was formerly the case.

Unions are prohibited from coercing employees to participate in union affairs and from charging excessive or discriminatory initiation fees. Unions also are now subject to the charge of unfair labor practices, if they refuse to bargain with employers, or if they attempt to coerce them into industry-wide agreements.

Unions are prohibited from coercing employers into paying for services that are not performed. This rather ambiguous provision is an attempt to curb limitation of output or *make-work* practices called "feather-bedding."

Jurisdictional strikes and *secondary boycotts* are forbidden as unfair labor practices, against which the NLRB can seek injunctions pending public hearings on the issuance of "cease-and-desist orders."

c. Administrative Changes. Important innovations in governmental machinery were made by the Taft-Hartley Act. The *membership of the National Labor Relations Board* was increased from three to five members. Its judicial functions were continued, but its powers of prosecution were placed in the hands of a new and important official known as *Chief Counsel.* He is not employed by the NLRB, but is appointed thereto independently by the President with confirmation by the Senate.

An *independent mediation agency,* presumably tripartite in character, representing workers, employers and the general public, took over the functions of the Conciliation Service in the U.S. Department of Labor.

Both employers and employees are given greater freedom to ask for *NLRB elections* to certify or to "decertify" a union representing workers, the union representing the majority of workers and possessing exclusive bargaining authority, and, finally, the appropriate or proper bargaining unit.

Neither management nor union can cancel an existing agreement without a *60-day prior notification.* Meanwhile strikes and lockouts are forbidden.

d. Miscellaneous Provisions of the Labor-Management Relations Act of 1947. Officials of unions seeking NLRB recognition must file affidavits disclaiming *membership in the Communist party* or in groups favoring overthrow of our government by force.

Unions must file detailed *reports on finances* and internal practices with the Labor Department to be eligible for the protection given them by the NLRB. Unions need not file such reports, but failure to do so implies irresponsibility as agencies for collective bargaining. Business corporations are required to file similar reports with the Federal Trade Commission, the Securities and Exchange Commission, and other regulative agencies of the Federal government.

The right of *free speech* was affirmed for industrial relations. No expression of opinion by an employer or a union official can be used as evidence of

an unfair labor practice, unless it contains a threat of coercion or a promise of specific benefit to secure compliance.

The guarantee of the *right of collective bargaining* was reaffirmed. Indeed, group negotiation was made mandatory rather than permissive. Labor and management representatives must meet at reasonable times and confer in good faith, but neither party is compelled to accept a proposal or to make a concession. Any negotiated agreement, however, should be reduced to a written contract, if requested by either party thereto.

e. Joint Congressional Committee. In conclusion, the measure called for the creation of a joint committee of 14 House and Senate Labor Committee members to report back to Congress by Mar. 15, 1948, on (1) ways of encouraging friendly labor relations, (2) means of encouraging productivity by guaranteed annual wages, profit-sharing and bonus systems, (3) internal organization and administration of unions, particularly those with union shop contracts, (4) employer labor policies, (5) welfare funds, and (6) administration of Federal labor laws. As a result of such conferences and practical experiences with the law, additions and modifications have been suggested. Meanwhile court tests of various provisions of the Taft-Hartley Act were sought.

Guide Questions on Text

1. Classify in several ways different types of labor organizations.
2. Contrast the American Federation of Labor with the Industrial Workers of the World as to organization, objectives, and weapons.
3. Similarly compare the American Federation of Labor with the Congress of Industrial Organization.
4. Show how labor organizations were restricted by
   a. legal doctrine of conspiracy;
   b. concept of combinations in restraint of trade.
5. How did amendment of the Sherman Act by the Clayton Act affect unions and their practices of collective bargaining?
6. What were the chief provisions of the Norris–La Guardia Act?
7. What innovations were made by the National Industrial Recovery Act on the status of unions? Why? How?
8. Give chief provisions of the National Labor Relations Act of 1935. Defend or criticize its general spirit and its particular features.
9. How were they modified by the Labor-Management Relations Act of 1947? Why? Were these modifications desirable or not?
10. What other innovations, if any, were made by this law? Why?

Topics for Investigation

1. Early struggle for existence of unions in England.
2. Organized labor in America before the Civil War.
3. Rise and fall of the Knights of Labor.
4. Industrial Workers of the World.

5. Trade unions outside the American Federation of Labor.
6. Constitution of some particular union.
7. Schism in American labor movement.
8. Political Action Committee.
9. Progress of British Labour Party.
10. Prospects of an American Labor Party.

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CHAPTER XXXII

PROGRAMS AND PROBLEMS OF COLLECTIVE BARGAINING

32–1. Status of Workers under Wage System. Under the feudal system serfs paid rentals in commodities and services for the use of their land. The development of capitalism substituted money rents and money wages for such payments in kind. There was also the social change from status, a condition fixed by birth, to freedom of contract to accept or reject particular conditions of employment and to move about from place to place in search of better opportunities. This gradual evolution from the medieval relationship of lord and serf to the modern one of employer and employee passed through a long transitional period of master and servant relationship. A servant was free but servile; he could leave an objectionable master or an unpleasant occupation, but he could not bargain effectively.

Karl Marx has outlined the history of labor into three stages: (1) ancient slavery, (2) medieval serfdom, and (3) modern wage slavery. This analysis has some elements of truth, but it is distorted by his use of such a prejudicial expression as "wage slavery." The contention of Marx was that under the factory system the employer, owning the instruments of production, could control the terms of employment so that the employee had merely the freedom of choice between compliance and starvation.

The "wage system," as it is more properly called, is a feature of modern roundabout, or capitalistic, methods of production, under which the employer advances to his workers a share of the final product of industry. Under a free price system the values of services, like those of commodities, are determined by relative demand and supply forces in a competitive market. The wages of plentiful, unskilled laborers, therefore, are low, while those of scarce and skilled workers are high. The cost of subsistence or a minimum plane of living puts a floor under wages, and the marginal product of a particular type of labor places a ceiling over wages, because no employer will pay a worker more than he is worth to him by his additional product. Between these two limits, however, bargaining is a factor in wage determination.

Just as some employers have combined for the price maintenance of their products, described in Part Seven, likewise many workers have organized to control the supply of particular types of labor; they have practiced collective bargaining to raise wages and to improve working con-

ditions. As indicated in the preceding chapter, devoted to the development of labor organizations, the former social inferiority and economic weakness of labor have disappeared; instead, increased political power has come with improved organization.

32-2. Nature and Types of Collective Bargaining. The expression "collective bargaining" is as indefinite as are the terms "wage system" and "freedom of contract." In its broadest sense, collective bargaining may be defined as group instead of individual competition and as agreements between organized associations rather than isolated individuals. The more pleasant term "collective negotiation" is now being substituted for the older expression "collective bargaining."

Specific practices of collective bargaining will be treated in this chapter. A case can be made for or against each of them. Some are desirable but others are undesirable. Some are necessary to secure better terms of employment or to maintain collective bargaining but others are not. Hence it is desirable to appraise every weapon of collective bargaining separately, as well as in relation to each other and to collective bargaining in general. The basic principle has become accepted and written into law, but particular forms of collective bargaining are debatable.

32-3. Origins of Collective Bargaining. Although collective bargaining has been given new forms and an added importance by the changes of the Industrial Revolution, it antedates modern industrialism. Indeed, collective bargaining is as old as, or even older than, capitalism and the wage system. It may be traced as far back as the medieval charters which the townsmen received from their local dukes or distant kings; these were essentially collective agreements containing certain privileges and specific exemptions from feudal obligations. Medieval guildsmen also practiced collective bargaining and had mutual understandings with their fellow members as to quality of goods, prices, output, and general working conditions.

32-4. Medieval Guilds and Modern Trade Unions. Interesting comparisons can be drawn between medieval craft guilds and modern trade unions as associations for collective bargaining. Essential differences, however, lay in the former absence of power machinery, the factory system, and large-scale production. In an age of craftsmanship and production by hand tools, an apprentice expected to become a journeyman, and a journeyman had the practical possibility of becoming a master workman. Considerable skill, but only a moderate amount of capital, were necessary. Moreover, master and apprentice worked side by side in the same shop. Industrial relations were personal and even parental. These differences in fundamental conditions must be remembered in comparing the collective negotiation of medieval craft guilds with that of modern trade unions and industrial unions.

32–5. Nature and Significance of Conspiracy. The first labor organizations in Great Britain were held to be criminal conspiracies under common law; statutes known as the combination acts were directed against them. In the early part of the nineteenth century union leaders were jailed or banished to Australia.

Even today in this country, the doctrine of conspiracy has more than mere historical significance in connection with collective negotiation. Consequently, it is necessary to know the general nature of a conspiracy, to be able to distinguish between lawful combinations of labor and unlawful conspiracies, and to differentiate correctly between legitimate contracts and illegitimate conspiracies, both of which are meetings of minds in collective negotiation, even though their purpose or method of accomplishment is very different. The following court decision is poignant.

> A conspiracy is a combination of two or more persons, by some concerted action, to accomplish some criminal or unlawful purpose, or to accomplish some purpose, not in itself criminal or unlawful, by criminal or unlawful means.[1]

One of the most serious features of a conspiracy is the legal implication that inactive parties thereto may be held responsible for unapproved acts of fellow conspirators in seeking their common end. Such an attitude was taken by the courts toward union members in some important decisions concerning labor relations and industrial disputes. On the other hand, as explained in Chap. III, the doctrine of limited liability has been generally accepted with business corporations, and the legal fiction of the corporation as a fiduciary person has sometimes permitted corporate officers to escape the consequences of their misdeeds by passing the responsibility for them on to the corporation, which could be fined but not imprisoned.

32–6. Collective Bargaining Freed from Conspiracy and Combination Doctrines. A combination of workers to raise wages or to improve working conditions, originally regarded as conspiracy, is now legal. But if it can be shown that a particular combination of workers exists for the express purpose of injuring an employer, it is in the nature of a conspiracy. To seek collectively a legitimate objective, such as higher wages or improved working conditions, by using unlawful means deliberately and directly, such as destruction of the employer's tangible wealth or intangible property rights, is also conspiracy.

The Norris–La Guardia Act, as was indicated, embodied in Federal law the general principle that any act which is legal when done by an individual is likewise legal when done collectively by a group. Like earlier British statutes, it repudiated the old doctrine of conspiracy in industrial relations.

Freedom from the doctrine of conspiracy, however, has not given labor organizations access to all weapons of collective bargaining. Moreover,

[1] *Commonwealth v. Hunt*, 4 Metcalf 111 (Mass. 1842).

as explained in the preceding chapter, unions were also attacked under the Sherman Act as combinations in restraint of trade. Injured employers, as illustrated by the Loewe Hat Company, were awarded triple damages for losses suffered by such combinations. Moreover, the Danbury Hatters and members of other unions have been held individually liable for the damages awarded. To be sure, the Clayton Act declared that unions were not to be regarded as combinations in restraint of trade; but that did not legalize all practices of collective bargaining, some of which continued to be viewed as interference with interstate commerce or as violations of the constitutional guarantee of property. Hence, it will be necessary in this chapter to examine more closely specific practices of unions and particular weapons of collective bargaining.

32-7. Wage Bargaining and Price Bargaining. The economic differences between the collective bargaining of business corporations and trade unions have been expressed as follows:

The modern corporation has taken over both of the bargaining functions of the masters of old: the *price bargain* and the *wage bargain*. In the first the corporation performs the *merchant* function, and its object is to get as high prices as possible from the consumer. In the second it performs the *employer* function, and its object is to give as low wages as possible to laborers.

Collective action by capital has not stopped with the corporation. The corporations themselves have become members of associations. In these associations it has generally been found advantageous to separate the two bargaining functions. *Manufacturers' associations*, "pools," and "trusts" are formed to deal with the price of products to consumers. *Employers' associations* deal with the wages paid to labor. Practically the same individuals may compose these associations; but their functions are totally different.[1]

The legal significance of this important economic distinction follows:

That capital and labor should be treated equally is a proposition fundamental to American law. But the dual bargaining functions of capital must be distinguished. The *price bargain* is something very distinct from the *wage bargain*. Trade unions do not deal with consumers at all. Their function is to offset the advantage the employer enjoys in bargaining about wages with the individual laborer. Equal protection of the law does not consist in treating a trade union like a *manufacturers' association* but in treating it like an *employers' association*. This is not class legislation but sound classification.[2]

It would seem, then, that trade unions should be regarded economically and legally as comparable with employers' associations, rather than as analogous to manufacturers' organizations. Neither labor organizations

[1] Commons, J. R., and J. B. Andrews, "Principles of Labor Legislation," rev. ed., p. 100, Harper & Brothers, New York, 1927.

[2] *Ibid.*, p. 128.

nor employers' associations, as such, should be confused with combinations in restraint of trade.

Although the state may object to certain weapons as illegal, and to particular policies as uneconomic, government should not restrict the right of either side to organize, even though it may well be forced to regulate methods of collective bargaining. Social justice is advanced by minimizing glaring differences in bargaining power and facilitating the organization of the weaker party. Such was the political philosophy that underlay the legalization of collective bargaining in 1933 and 1935, as described in the preceding chapter.

32–8. Spheres of Legislation and of Collective Bargaining. Labor organizations were primarily concerned with wages, hours of work, and rights of collective bargaining. They seemed singularly indifferent to general working conditions, especially those of unorganized groups. It was legislation that attacked such maladjustments as child labor and insanitary living conditions. Of recent years, however, labor organizations have become vitally interested in these broader problems reaching beyond their own immediate interests and particular groups.

The raising or maintaining of wages, in contrast, was attempted earlier by labor organization than by state legislation. This is particularly true of adult male workers, with whose wages government was more reluctant to interfere than with their hours and working conditions. The existence of labor organizations, at least among skilled adult male industrial workers, made the extension of the police power of the state not so necessary in their case as in that of women and children, whose inferior bargaining power placed them in even greater danger of exploitation.

32–9. Laws Concerning Payments of Wages. Before the passage of minimum-wage legislation, discussed in Chap. XXIX, the state was reluctant to encroach on the constitutional guarantee of freedom of contract implied in the right of property. Wage negotiation, consequently, was left to individual or collective bargaining.

Government formerly interfered only to prevent fraud in the payment of wages. States legislated frequently as to the manner of wage payment but rarely as to the rate of wages or the amount of earnings. For example, laws were passed to make illegal the payment of wages in script instead of cash. If the worker were paid in script or company labor checks, he might be forced to buy at the company store; profiteering by employers and exploiting of employees might ensue.

States have legislated also against the withholding of wages from workers. Employers have been compelled to pay wages promptly and regularly. Delay in remuneration would inflict severe hardship on those workers without a reserve of past savings on which to live. It might force employees to become hopelessly in debt, sometimes at ruinously high rates of

interest and in unjust amounts. If carried to the extreme and accompanied by an extension of credit by the company store, a condition of peonage could result. By the bonds of chronic indebtedness and the threat of imprisonment for vagrancy, if escape were sought by flight, the Mexican peon and the southern Negro were formerly held to enforced labor and involuntary servitude.

32–10. Methods of Remuneration. *a. Wages and Earnings.* It will be remembered that wages are payments for short periods of time or for particular tasks accomplished, whereas earnings are amounts paid for longer periods of time or for aggregate tasks accomplished. Wages afford scales for computation, but earnings are actual pay checks or cash to take home.

b. Labor Costs. Labor costs are pay rolls in relation to production. They are ratios between what workers get and what they do. Management is interested not so much in lower earnings as in lower wages per unit of product. Employers are favorable to higher earnings provided production is increased proportionately or more than proportionately. Profits are menaced not by high wages but by excessive labor costs. It is possible and desirable to have large earnings despite low labor costs.

Management favors a system of payment that serves as an effective stimulus to increased production, if it is not accompanied by corresponding waste or deterioration in quality. On the other hand, the employee is opposed to any system of wage payment that tends to reduce total earnings or wages per unit of output. Organized labor, as we shall see, opposes management's attempt to drive workers by pace setting; it therefore views with suspicion financial incentives to step up their efforts. Under the lure of higher wages for increased production, workers are tempted to speed up or to work overtime until physical exhaustion or permanent impairment of health results.

c. Time and Piece Wage. The two basic systems of remuneration are the time and the piece wage. Other methods are modifications of these fundamental forms of wage payment. Under the time-wage system, the basis is a unit of time, such as an hour, a day, or a week. Salaries are time wages expressed per month or per year. Under the piece system, the unit of payment is a specific amount of product. Professional fees and commissions resemble piecework payments.

Time wages are used where the measurement of output of an individual worker is difficult, as in construction work done by gangs of unskilled laborers. With time wages it is customary for the employer to attempt to quicken the workers who seek to adjust their pace to that of the slower workers. Reliance is placed on foremen, who have been termed "the first line of defense of industry." In the past, foremen have often been selected, like the slave overseers of antiquity, because of their power to drive the

workers to increased productivity. Verbal abuse and the threat of prompt discharge have been used as whips on the backs of the idle, the slow, and the inefficient.

Piecework is common among the semiskilled operators of machines, where dexterity in simple operations is required, but where real skill and expert craftsmanship are not involved. With the substitution of piecework for time payment, the inspector replaces the foreman and time clerk. He passes on the quality of the product; the number of accepted pieces determines the amount of earnings. Piecework is less conducive to soldiering on the job than is time work. Hence employers have sought to introduce it wherever possible.

Although the individual worker may favor piecework because of the lure of greater earnings, organized labor has often been hostile to this system. It encourages speeding up workers and it is easy of abuse. After production per worker has been increased, management has sometimes cut the rate per piece. Either the employee must suffer a loss of earnings or he must speed up to a still higher level of production. Wherever the piece rate could be fixed in a rather arbitrary manner by the employer, the greater efficiency of the workers has often been penalized by a cut in the piece rate. Bitter past experiences have made the workers suspicious that proposed changes in methods of computing piece rates may be devices to cut down their actual earnings.

d. Task Wages and Premium Plans. The task wage is a compromise between the time and the piece system. Wages are fixed on a time basis; but unless the worker performs a certain standard amount of work within the allotted time, he suffers a corresponding loss of earnings. This system was in vogue some years ago among clothing workers, where it intensified the sweatshop evils.

Premium plans also are compromises between time work and piecework, but, in contrast to the task-wage system, premium plans are positive, not negative. There is an existing wage scale based either on the time or on the piece system. A standard amount of output or a given period of time is agreed on as the basic unit; an excess of production or an increase in speed beyond this previously agreed upon standard is rewarded by an addition to the regular wage.

32–11. Necessity of Collective Bargaining. Collective bargaining by organized labor results from the disadvantages of the isolated worker in individual bargaining. Although labor enjoys freedom of contract and equality before the law, there are economic differences between the two parties to the wage contract, which impair the bargaining power of the worker.

Among the chief disadvantages of the individual worker in making a wage bargain are the following. Labor is a service and, therefore, similar

in nature to a perishable commodity. Time spent in finding employment represents a loss of working hours and, hence, of wages. The proffered wage may be lower than the competitive rate of wages for a given type of work, but its refusal may mean unemployment. Loss of wages to the worker is frequently more serious than loss of profits to his employer. The laborer has no great surplus of past savings on which he can draw in a protracted period of unemployment.

Another disadvantage of the unorganized worker is his inferior knowledge of general conditions of employment, as compared with that of the employer or with that of the salaried secretary of a labor organization. He does not know where to go in order to better his condition. Moreover, it is not easy for the worker and his family to move quickly from place to place under the lure of a slight wage differential. The immobility of labor puts it at a competitive disadvantage. It results in the existence of excessive labor reserves in some industries and communities.

A final disadvantage of the worker is the frequent existence of understandings among large employers of labor as to wages and other conditions of employment. A gentleman's agreement may prevent them from competing actively for workers and thus forcing wages up to their natural or competitive level. Associations of employers have been reluctant to "spoil the labor market." There has been some very successful collective bargaining among employers.

32–12. Primary Objectives of Collective Bargaining. The chief purpose of labor organizations is the raising of wages or the maintaining of customary standards of living against a rising price level. Closely associated with this objective of higher wages is the desire of the workers for shorter hours and increased leisure. These two primary aims of collective bargaining have been fused in the following rhyme.

> Whether you work by the piece or work by the day
> Decreasing the hours increases the pay.

The securing of these two primary objectives of collective bargaining is conditioned by the strength of organized labor. Hence another primary aim of unionism is the maintenance of the right and power of collective bargaining. Unions seek to keep and to strengthen their own prerogatives and weapons. They are bitterly opposed to those practices or restrictions which sap the effectiveness of collective bargaining or weaken their own organizations.

32–13. Secondary Functions of Labor Organizations. Unions sometimes maintain benefit programs for their members. Often they are affiliated with fraternal associations. Labor organizations also serve as employment bureaus.

Some labor organizations perform important educational work. Periodicals are published and forums conducted. Lectures are given and courses offered in labor economics. Current events of general interest or of especial significance to workers may be discussed. Business meetings are held that give practice in public speaking and familiarity with parliamentary procedure.

A trade union or a local federation of labor may become a social center for its members and their families. If the organization is large and prosperous, headquarters can be maintained in some commodious and convenient building. Meeting places, reading rooms, recreation halls, and other attractions may be added to the necessary offices and committee rooms, essential for the transaction of ordinary union business. These social features, however, are now generally provided by an affiliated fraternal organization or by a community center patronized by all citizens.

32–14. Essentials of Collective Bargaining. Collective bargaining or, to use the better expression, collective negotiation was defined at the beginning of this chapter as efforts to reach agreement between organized groups instead of isolated individuals. It is industrial democracy, in contrast to the opposite extremes of industrial autocracy and industrial anarchy.

As most groups are too large to permit pure democracy of the town-meeting type, collective bargaining must function as representative democracy. It is axiomatic that democracy exists only when those represented are permitted to choose their own representatives. The secret ballot has come into existence to prevent intimidation at the polls. It is equally essential that the workers be permitted to bargain collectively through representatives of their own choosing. It is similarly necessary that they use the secret ballot to choose between individuals as their representatives and to express their preferences for one labor organization over another. There must be no coercion of employees either by company or by union.

As collective bargaining represents negotiations between groups instead of between individuals, it is imperative that both sides be organized effectively. Otherwise, the situation constitutes merely fictitious or one-sided collective bargaining. Fair collective bargaining may be illustrated by joint conferences and trade agreements between parties of nearly equal bargaining power. Their aim is the reduction of industrial differences by peaceful discussion with the ultimate formation of a compromise that becomes the accepted usage of an industry or occupation.

Finally, it is just as fair and just as necessary that both parties be jointly responsible as it is that they be nearly equal in bargaining strength. Indeed, power without responsibility is as dangerous in economic relations as it is in political organization. Otherwise the situation is one of dictator-

ship and not democracy, or license instead of liberty. If either party to an agreement is not responsible for keeping its part of the bargain, collective negotiation becomes a mockery. If the state undertakes to promote collective bargaining, it must be prepared to set up rules of the game and to enforce decisions.

32–15. Interpretations of Collective Bargaining. It is easy to agree on the desirability of collective bargaining and, indeed, on its actual necessity. But to interpret collective bargaining in terms of various practices is more difficult. Thus the labor delegation withdrew from President Wilson's postwar conference between capital and labor, because of failure to come out from behind platitudes in the discussion of collective bargaining. The workers insisted that collective bargaining be defined more specifically as inclusive of certain practices, such as the closed shop, which labor regarded as essential to it. Although all members of the conference were willing to endorse the general principle of collective bargaining, representatives of the employers were not willing to accept these concrete and partisan interpretations of collective bargaining.

The same problem of interpreting the general principle of collective bargaining in terms of specific practices and existing organizations reappeared in the recovery program of President Franklin D. Roosevelt. The administration affirmed the government's position in favor of the broad principle of collective bargaining but refused to accept the closed shop as its proper and universal expression. Indeed, the general inference was in favor of the nondiscriminatory shop. On the other hand, the steel industry was forbidden to write company unionism into its industrial code as an official interpretation of the general principle of collective bargaining.

This issue of the open versus the closed shop, like Banquo's ghost, continued to make its unwelcome reappearance from time to time at capital-labor conferences that otherwise might have been love feasts. President Roosevelt's National Defense Mediation Board, like President Wilson's labor conference, came to naught when labor representatives again withdrew because of failure to endorse the closed shop and to include this particular form of collective bargaining as an essential part of the acceptable definition. The general principle of collective bargaining had already been written into Federal law. Its interpretation in terms of specific practices remained a matter of dispute and discussion.

Organized labor has consistently and insistently attempted to inject such concepts as the closed shop into its interpretations of collective bargaining. It has been equally firm in its refusal to regard company unionism as pertinent or proper collective bargaining. It is now our task to analyze the fairness, the effectiveness, and the social desirability, or the reverse, of various methods of collective bargaining, of which the open and closed shop issue will receive primary consideration.

32–16. Weapons of Collective Bargaining. Devices for collective bargaining may be classified as those of employers or of employees, as those of consumers or of producers, as peaceful or militant practices, as radical or conservative weapons, as legal or illegal practices, as open or secret weapons, as economic or wasteful methods, and, finally, as socially desirable or socially undesirable practices of collective bargaining.

Strikes, for example, are militant weapons of collective bargaining, used by employees organized as producers. The union label is a peaceful and socially desirable weapon of employees organized as consumers. Sabotage is a secret, uneconomic, and socially undesirable practice resorted to by some radical labor organizations; it disrupts production and destroys property. The injunction is a legal weapon, open to both employees and employers, but used more generally and effectively by employers.

32–17. Open and Closed Shop. *a. Definitions.* The open shop is one in which both union and nonunion men may be employed, but many so-called "open shops" have been closed to union men, *i.e.*, the employer would frankly or secretly employ only nonunion men. Certain employers have professed to maintain the open shop, but a careful inspection revealed that union men were not employed at all or only when nonunion men were not available; union men were discriminated against in dismissals, promotions, and other matters. The open shop that was free from discrimination against union men was rare. This has been one of the strongest arguments against it, namely, that the so-called "open shop" was frequently a closed shop, *i.e.*, closed to union members, sympathizers, and organizers. For these reasons the open shop has often been called a "nonunion shop."

The closed shop is one which employs only union members. It may be operated by either the open or closed union. In the closed shop with the open union, the employer may hire whom he pleases; but if he employs a nonunion man, the latter must join the union after he begins work. The closed shop with the open union is known as the "preferential union shop," or more simply as "the union shop."

In the closed shop with the closed union, commonly called the closed shop, the employer may employ only men who are members of unions. Management's power to discharge a workman, as well as its power to hire one, is limited. The causes of the discharge must be passed on by union officials, or other organized workers will walk out. Efficient workers who lose their standing in the union must be discharged. Less efficient workmen who have union membership and seniority rights must be hired or retained. The closed shop with the closed union is a labor monopoly that is difficult to defend. It is an autocracy of labor that discriminates against capable workers who are not members of unions, entrance into which is sometimes difficult and often expensive.

The antiunion shop, now illegal, was equally discriminatory, in that it forced workers to give up their right of union membership. Many nonunion shops were openly or secretly hostile to the very principle of collective bargaining. Industrial espionage was used by some employers to eliminate labor organizers and to prevent union organization.

The Taft-Hartley Labor Relations Act of 1947 forbade the closed shop, but it permitted the union shop, if voted by a majority of the employees, and if agreed to by the employer. Many states also have outlawed the closed shop.

b. Maintenance of Membership. Maintenance of membership is a compromise arrangement that freezes a particular situation either indefinitely or for a specific period of time or for the duration of a particular agreement. Workers are not compelled to join a union, but those who do so or who have already done so cannot leave the union and still retain their jobs in the unionized plant. There may be an escape clause in the agreement permitting workers to reject or to renounce union membership during a short interval, after which their exit from union membership is closed by all doors except the unpleasant one of quitting the job, although all entrances to union membership are left wide open.

c. Arguments Centering about Open and Closed Shop Issue. Employers' organizations have conducted a national campaign in behalf of the open shop. Organized labor has been equally insistent on the closed shop. The literature of both sides has been propagandist and emotional, rather than objective and unbiased. Every economic problem, however, has its two sides; any program has both advantages and disadvantages.

Employers regard the closed shop as un-American, monopolistic, and unfair to both industry and unorganized labor. They charge that the public welfare is endangered by the closed shop. They indict it as the cause of many economic ills and of much social injustice. The chief contention of employers is that the closed shop prevents management from running its own business without outside interference. Employees claim that the closed shop reduces all workers to the dead level of mediocrity under union control of output, wages, and working conditions. It deprives unorganized workers of their "constitutional right of freedom of contract" to sell their labor as they see fit. The closed shop, they allege, raises the costs of manufacture and hence the prices of goods to consumers. It contributes directly and indirectly to unemployment.

Organized labor replies that the open shop exists only in name and that most open shops are really antiunion shops. The movement in favor of the open shop is merely a disguised attack upon organized labor. The closed shop with the open union is regarded by its advocates as democratic; the open shop or nonunion shop is viewed as autocratic. Employees, as well as employers, should have a voice in the determination of industrial conditions and a vote in the selection of their industrial representatives.

Labor leaders contend that the closed shop is vital to effective collective bargaining, without which the exploitation of workers would result. If modern industry standardizes processes and products, unions likewise should standardize conditions of employment. If business follows the one-price system for its commodities, labor should do the same for its services. If large employers seek through trade associations concerted action against substandard and "chiseling" firms, union labor should likewise seek through the closed shop similar protection against submarginal and unorganized workers. Many advocates of the closed shop justify coercion on unorganized laborers to join unions. The nonunion employee who works beside a union man receives the benefits of collective bargaining in wages, hours, and working conditions. Why should he not be compelled to join the union and assume some of its burdens?

32-18. Check-off. Under this system management performs some of the administrative work of the union. Employers deduct union dues and fines from the wages of their employees as directed by officials of the entrenched union; these funds are subsequently turned over to the business agent of that union. The check-off system rarely exists outside the closed or union shop, although the latter frequently exists without the former. The check-off was common in the highly organized coal mines of Pennsylvania.

The Taft-Hartley Labor Act of 1947 permitted the check-off, if the employer agreed and if the individual worker authorized in writing such pay-roll deduction for his union dues.

32-19. Negotiation through Business Agents and Shop Stewards. Although interpretation of collective bargaining in terms of the open and closed shop is highly controversial, it is clear that collective negotiation, to be both democratic and effective, must imply the right of workers to bargain collectively through representatives of their own choosing. In other words, it involves the rights of affiliation, should it be desired, with a national union, and of representation of the workers by a negotiator who is employed by the union rather than by the company.

Such an individual, formerly known as a "walking delegate," is now more commonly and properly termed a "business agent" of the union. In contrast, shop stewards are union members who work in the company plant and who do not devote all their time to union business.

Conferences between shop foremen, representing management, and shop stewards representing union, adjust minor matters of significance only to workers in their respective departments. If the dispute seems important or if it remains unsettled, the issue is carried to higher and broader levels of negotiation by a routine grievance procedure, generally agreed on in advance by previous negotiation. Both shop steward and shop foreman are usually present when the aggrieved worker presents his case to the plant superintendent or the personnel officer of the company. The business agent

of the union is his counsel, both in negotiation and in arbitration procedure, should it be found impossible to settle the difficulty directly between the two parties concerned, or should the particular issue in dispute involve important fundamental principles. The support of the worker and the pressure on management lies in the implied or expressed threat to call a strike if a settlement satisfactory to the union is not achieved. The popularity of a union among its actual and potential members grows with the number of individual grievances settled to the satisfaction of the workers.

32–20. Union Participation in Grievances. Some employers, who avowed their readiness to meet with representatives of workers chosen from among their own employees, were reluctant to have negotiations and agreements with individuals outside their own plants. Formerly, many employers repudiated and refused to deal with professional labor leaders, who, so they claimed, went from industry to industry, sowing the seeds of discontent, from which would grow union organizations, and from which they would finally reap a crop of grievances and strikes.

Labor leaders point out in reply that industry itself creates social unrest by the exploitation of unorganized workers. It is true that labor leaders do organize unions, which give to the workers a medium through which to express their grievances and a means by which to right them. Strike duty is merely one of the functions of labor leaders, who sometimes settle or prevent, rather than cause, industrial conflicts. Workers are not sufficiently trained or informed to do such work for themselves. If employers and associations of employers can hire legal counsel and management experts, why should not employees have a similar right to use the services of the business agent of the union to which they pay dues?

Few employees would dare to organize their fellow workers or to push their claims against those of management. To do so would cultivate an immediate or a deferred dismissal. It was formerly easy for an employer to find an excuse for firing an employee who had rendered himself obnoxious by his activities in collective bargaining. Moreover, tacit agreements among employers made it difficult for a discharged worker to obtain employment elsewhere. On the other hand, hope of advancement was often a sufficient temptation to induce the plant representative of the employees to sell out their interests to the employer; hence the necessity of outside and independent labor leaders.

32–21. Company Unions. *a. Character.* Company unions are organizations of the workers of one plant or business corporation, whose employees elect representatives to treat with their employers as to wages, hours, and general working conditions. They were generally superimposed from above by management. Unlike trade unions or industrial unions, they rarely grew up naturally from below among the workers themselves. Most company unions were organized on the initiative of the employer or

fostered by the personnel department of the company. They frequently featured profit-sharing schemes, welfare projects, and pension systems. The general aims of company unions were the development of a closer co-operation between men and management and the production of industrial good will as a valuable business asset.

Company unions developed apart from, and often in conflict with, trade unions and industrial unions. In most cases, members of company unions were not members of trade unions. In some cases, workers formerly were prevented from becoming members of trade unions while in the employment of the firm that maintained such a company union. Most company unions were open-shop organizations, which meant that they were frankly or secretly hostile to trade unions. At best, company unions were competitive organizations seeking membership among workers who might otherwise have joined trade or industrial unions in their respective occupations. Consequently, company unions were indicted as sham organizations of labor under the control of the employer instead of the workers. They represented industrial paternalism buttressed by welfare projects of management. They repudiated industrial democracy beset by difficulties of organization and dangers of conflict. It is clear that company unions were of the workers but not by the workers; it is controversial to what extent they were for the workers.

b. Criticisms. Although collective bargaining may be interpreted as inclusive of all group negotiations, such a broad definition means little. The first essential of effective collective bargaining is the right to belong to a union, which can secure the support of the entire organized labor movement.

Effective collective bargaining involves also the employment of professional labor leaders, not the utilization of plant employees. Representatives of the employees in a company union may be bribed by the prospect of promotion to sell out the interests of their fellow workers, or they may be prevented by the possibility of discharge from pressing too far their own demands. Unlike Oliver Twist, the employee representative will not offend the management of his own company by daring to ask for more for himself and his fellow industrial orphans.

Finally, company unions are defenseless except for the rather impotent weapon of public opinion, which management's department of public relations can use even more effectively than the workers. Company unions must fight their industrial battles without such weapons as the strike or the threat to strike. The employer may be fair, reasonable, and even sympathetic, but, if not, there is little possibility of coercing him by utilization of some of the common but effective weapons of industrial warfare. For these reasons, employee representation through company unions cannot be regarded as an effective instrument of collective bargaining.

32–22. Yellow-dog Contracts. In order to prevent an infiltration of union members, some employers formerly required of each applicant for work a written statement that he was not a union member. In order to guard against his subsequent affiliation with an independent union, management sometimes made a prior condition of employment the signing of an agreement by every prospective worker that he would not become a member of a trade union or of other specified labor organizations as long as he remained in that employment. Such agreements, frequently stigmatized as "yellow-dog" contracts, were bitterly opposed by trade unionists. Although company unions sometimes competed fairly with trade unions for membership, they were often forced on employees by the imposition of yellow-dog contracts.

Several states passed laws preventing employers from denying to their employees the right of membership in unions. Employers were also forbidden thereby to discharge those employees who belonged to labor organizations because of such union membership. Although many of these laws were at first regarded as unconstitutional or were subsequently found to be unenforceable, later state laws of this general nature were valid and effective. Yellow-dog contracts, now illegal, are of mere historical significance in illustrating the many obstacles encountered by unions in the path of progress toward collective bargaining.

The national Congress in 1932 passed the Norris–La Guardia Act, which forbade a Federal court to issue an injunction sustaining yellow-dog contracts or to punish a violation of them by contempt of court procedure. The National Industrial Recovery Act of 1933 prohibited coercion of employees by employers in matters of belonging to or refraining from joining "independent" (company) unions. As this law was declared unconstitutional, the same general principle was carried over into the National Labor Relations Act of 1935, which, as we have seen, guaranteed to workers the right of collective bargaining through representatives of their own choosing, and which also forbade discharge and discrimination because of union membership.

32–23. White Lists and Black Lists. Employers sometimes maintained their own employment bureaus and prepared "white lists," which enumerated those employees who had been found by management to be faithful, loyal, and efficient. They were given preference in employment, unless the principle of seniority had been imposed by unions.

Associations of employers also prepared "black lists" of employees who had been active in labor organizations. A tacit agreement among employers prevented the reemployment of such workers in other plants. The black list was defined as a boycott by employers against the labor commodity of workers. The fear of black-listing, like the hope of white-listing, was an effective deterrent to many employees from participation in industrial disputes. The next chapter will treat boycotts.

The old doctrine of conspiracy, so frequently used against labor organizations for similar actions, did not apply formerly to black-listing by employers. Although many states legislated against such practice, these early laws gave labor little protection. Overzealous legislation by the Federal government, like that by individual states, was declared unconstitutional. A Federal court once ruled that an employer had the right to keep a record of men discharged for union membership and that he might lawfully invite its inspection by other employers.[1] This situation was drastically altered by the National Labor Relations Act. Employers cannot now discharge employees merely because of their activity in labor organizations or because of their participation in lawful industrial disputes. Companies have been forced to rehire discharged workers and even to reimburse them for time lost through such discharge, when it was subsequently proved to be a discharge primarily for legitimate union activity.

32-24. Fair Lists and Union Labels. These are devices to organize workers as consumers, just as the union shop organizes them as producers. In contrast to boycotts, which are negative in that they oppose the use of certain products, fair lists and union labels are positive or promotional. They are defensive weapons of employees, comparable to the white list of an employer.

Employers conciliatory to unions are listed as fair. Commodities made under good working conditions in union shops are so labeled. On the contrary, firms that do not agree to some or all demands of certain unions have been stigmatized by them as unfair to organized labor. Pickets with such placards have advertised this opinion to prospective patrons and workers at the "unfair" firm. Such action by unions is really a boycott against the employer. It is similar in character to the black-listing of workers by employers.

Consumers' leagues maintain lists of firms that manufacture their products under favorable working conditions. The aims of such organizations are excellent, but they are rarely realized because the average consumer will not consult a list of approved firms before making purchases. Some distinguishing mark placed conspicuously upon the salable commodity is more effective.

The AFL has striven to give publicity to union labels and to educate its members in the consumption of union-made goods. It publishes regularly these various insignia in its periodicals. The potential effectiveness of such a weapon among the millions of organized workers and their families is apparent. The courts have generally upheld the legality of union labels and pointed out their similarity to corporation trade-marks. Some states have passed laws to protect the use of union labels.

The Blue Eagle of the National Industrial Recovery program of 1933 was an official insignia placed on the products of those firms which complied

[1] *Boyer v. Western Union*, 124 Fed. 246 (1903).

with the new regulations. It sought to induce consumers to purchase only those commodities made under approved industrial codes. The Blue Eagle stamped on merchandise was in imitation of the union label of workers and the trade-mark of manufacturers.

32–25. Restriction of Output. *a. Counterweapon to Pace Setting.* Because of the fatiguing nature of modern industry, organized labor not only has reduced its hours of work but also restricted its units of production within a given period of time. This action has been defended as a counterweapon to the employer's attempt to speed up workers or to stretch out their energy. Machinery can be geared to such a speed that the worker can be taxed continuously to his utmost exertion. Pace setting can be done also by employing some exceptionally skillful workers for the express purpose of setting a high standard of especially rapid production. Other workers on the same machine or on the same job are urged to similarly great production under threat of discharge or a cut in wages.

The most flagrant abuses of pace setting were to be found in the sweated industries. But pace setting has flourished also in some large factories where wages have been high and hours short. For example, the assembly line in automobile plants is conducive to speeding up, because each highly specialized worker must do his particular task to the tempo of the swift and steady flow of mechanized production. The stretch-out was common in textile mills, which might increase the number of looms for which one weaver was responsible.

Organized labor has retaliated against pace setting by deliberately slowing down and by arbitrarily limiting the number of units of product to be completed within a specified period of time. Thus the laying of so many bricks, and no more, might be considered a fair day's work in bricklaying by union workers. Weavers might similarly agree to tend so many looms and no more. Unorganized and unskilled workers likewise come to a tacit understanding among themselves about limitation of output. A new worker soon learns that he is regarded with suspicion by his fellow employees if he works so rapidly that he threatens to "kill the job."

Restriction of output has been regarded as a leveling-down process in comparison with the leveling-up process of pace setting by speeding up or stretching out workers. In the former case, the output of the poor worker is the standard of labor; but in the latter case, that of the rapid worker is the standard.

b. Aims. Restricting output has two objectives. One aim is the protection of the worker's health against the fatiguing character of modern industry. There is much to be said on this ground in favor of a reasonable limitation of output as a necessary defense mechanism of labor against speeding up beyond average human capacity.

The other aim of restricting output is less justifiable, for it arises from the fallacy of making work. It is thought that the rapid worker would

lessen the total amount of labor and that limitation of output would spread employment over a longer period of time and would, therefore, create additional work. But restriction of output creates additional employment only apparently, only temporarily, or only locally. Although at a given time and within a particular occupation the amount of work may be limited, this attempt to stretch out employment by a restriction of output is a selfish and shortsighted policy. Restriction of output tends to raise the price of the product, to increase costs of living, and to lower the real wages of all workers. At best, one group of workers may profit, but at the expense of those who do not practice limitation of output. If all workers did so, the national income would be decreased and real wages would be reduced.

In conclusion, it may be said that both inhuman pace setting by employers and ignorant output restricting by employees are mistaken economic policies. Individual capacities and the demands made on them by particular occupations differ so greatly that any fixed pace or output may be unreasonably high or low.

32–26. Limitation of Apprentices. Monopolistic control over the supply and, hence, over the price of some commodities has long been practiced by capitalists. Similarly, monopolistic control over the supply of certain types of labor and, hence, regulation of wages therein has likewise been attempted by some workers. Limitation of apprentices, for example, is an attempt to create an artificial scarcity in the supply of a given type of labor so that its wage can be raised to or maintained at an unnaturally high level.

Both limitation of apprentices and restriction of output are as old as the medieval guilds. In an age of craftsmanship, apprenticeship was trade instruction under the personal supervision of a master worker. Limitation of the number of apprentices and extension of the period of apprenticeship were defended as necessary devices to achieve satisfactory instruction in the trade and to maintain proper standards of workmanship in the industry. Power machinery, however, caused replacement of the skilled craftsman by the semiskilled machine operator. In most large factories today, the original concept of apprenticeship is a mere fiction. Employers or their plant managers have little time, ability, or inclination to teach new employees their trades. Where the machine has displaced the craftsman, the machine helper has replaced the apprentice. The terms "apprentice" and "journeyman" in many occupations have become mere titles of classification between the older and better paid workers and the younger and less experienced ones. The more modern and common terms are machine "operator" and "assistant" or "helper."

Limitation of apprentices is similarly defended on the same two grounds. One object is to improve the quality of work, and the other is to raise the wages of those workers engaged therein. In spite of the prevalence of the machine, many occupations are still done by hand. Illustrations are the building trades, including carpentry, plumbing, masonry, and bricklaying.

Such work requires skill in the handicrafts, which can be developed only by manual performance under personal instruction. Boys cannot effectively learn these trades if there are too many apprentices to each journeyman. Where organized labor is sufficiently strong to express itself on this point, a certain ratio of journeymen to apprentices is demanded. Although organized labor has been more interested in limiting apprentices than in lengthening apprenticeship, the highly skilled trades have sought and secured both of these aims. The learned professions also have lengthened apprenticeship by insisting on graduation from college before admission to professional schools; they have likewise limited the number of apprentices by a careful selection of candidates.

32–27. Effectiveness of Collective Bargaining in Raising Wages. How far, if at all, labor organizations can raise real wages in general is a controversial point of economics. Although collective bargaining is no longer regarded as conspiracy, it is not always so effective as is commonly supposed. Labor organizations are confronted with natural economic laws, as well as with man-made statutes. There are economic margins as well as legal limitations.

a. Upper and Lower Limits. Theories of wages include the marginal-productivity theory, the bargaining theory, and the subsistence theory. The wage paid for each type of labor is regarded chiefly as the result of two forces: first, the scarcity of that type of labor relative to the demand for it, and, second, the bargaining power of that particular group of workers. Collective bargaining is a device by means of which labor has sought to overcome the bargaining disadvantages of the single worker and to ensure payment of the full marginal product of that type of labor. It is doubtful that collective bargaining, even by highly organized workers, can secure more than the marginal product of any type of labor. If a worker cannot produce value in commodity or service equal to his wage cost, he will not ordinarily be employed indefinitely. A group of workers may raise wages arbitrarily to so high a level that the increased costs of production cannot be absorbed in the price of the product, particularly so if the demand for that product is relatively elastic. In this event the employer will be forced to shut his plant temporarily or to go out of business permanently.

There is a lower physical or social limit to wages, just as there is a higher economic limit. This lower limit was originally regarded as the physical level of subsistence. It is now regarded as the social level of a minimum standard of living. If an occupation cannot pay a decent living wage, it is condemned as a parasitic industry that should be put out of its misery. Society must insist on a living wage; it cannot tolerate a dying wage. If submarginal workers cannot earn a minimum wage, they should be regarded as unemployables, to be lifted out of the swift stream of economic competition and to be laid on the banks of social rehabilitation. Like broken-down

and unsafe automobiles, to use a different figure of speech, submarginal workers should be ruled off the highways of economic progress in the interest of public safety and social welfare; they should not be permitted to jeopardize the wages of normal workers or to lower their planes of living. Such action requires minimum-wage legislation by the state; this social philosophy was the basis of the Fair Labor Standards Act, explained in Chap. XXIX.

Between the upper economic limit of marginal productivity, representing profitability, and the lower legal limit of minimum-wage legislation, expressing a social standard of decent living, the factor of collective bargaining can and does affect wages.

Although some economic theorists question the ability of trade unions to raise the general level of real wages above a natural or competitive rate, as fixed by the forces of supply and demand, it does not follow that collective bargaining is futile, even if it can do no more than secure for organized labor its full marginal product. Many labor leaders contend that collective bargaining on the part of workers is necessitated by the bargaining disadvantages of individual workers. Collective bargaining prevents employers from taking advantage of the ignorance or helplessness of their workers by paying them wages below their full marginal product, as fixed at any given time and place by the economic forces of supply and demand for a particular type of labor.

b. Monopolistic Practices. Monopoly power and bargaining strength can increase the wages of strongly entrenched groups of workers, but only at the expense of other workers and the consuming public. But most labor leaders, like ordinary businessmen, are more interested in the economic welfare of their own groups than in a broad humanitarianism.

A trade union of sufficient power, let us repeat, can restrict the number of its members by a limitation of apprentices and thus create an artificial scarcity of that type of labor. By the use of such monopolistic power as the closed shop, accompanied by the closed union, a powerful labor organization could definitely limit the supply of that type of labor. Hence it was possible to raise the wages of some particular group of workers in a manner similar to that by which certain industrial monopolies succeeded in raising the prices of their products.

If the wages of one labor group are raised in such fashion, the frequent result is that the prices of those products into which that labor enters are, in turn, raised. Hence costs of living for other workers are increased. Money wages must be advanced proportionately as costs of living increase, if real wages are to be maintained. Therefore, it is contended that the whole movement is one of a vicious circle. As money wages go up, prices go up, unless productivity is increased. Unorganized workers who have not enjoyed an increase in money wages proportionate to their increase in costs

of living, suffer a reduction in real wages. Such collective bargaining merely benefits the organized groups at the expense of the unorganized.

c. Conclusion. Finally, let us turn to the argument from experience. It is true that the development of trade unionism since the Industrial Revolution has been accompanied by an increase not only of money wages, but also of real wages for labor in general and for organized labor in particular. This relationship may not necessarily be a causal one, however, for the greater wages of labor today are due to other things, such as modern technology and increased control over the forces of nature. Nevertheless, without the development of labor organizations and collective negotiation, labor might not have received so large a share of this greatly increased national income. Today, the economic tug of war, represented by the process of distribution, is between competitors or monopolies of more nearly equal bargaining power.

Guide Questions on Text

1. *a.* What do you understand by the wage system?
   b. Is it exploitation, as commonly charged? Why or why not?
2. Give the important disadvantages of the individual worker in bargaining with his employer. Which can be overcome by collective bargaining?
3. *a.* What is a boycott? How is it effective?
   b. Distinguish between primary and secondary boycotts.
4. Distinguish between the accomplishments of legislation and those of collective bargaining in the improvement of industrial conditions.
5. *a.* What do you understand by collective bargaining?
   b. Why not substitute the expression "collective negotiation"?
   c. What practices of unions do you regard as essential to effective, but legitimate, collective bargaining? Why?
6. *a.* Distinguish between wage bargaining and price bargaining.
   b. Is this distinction significant? Why or why not?
7. What are the ordinary methods of remuneration in industry?
8. *a.* What is meant by labor costs?
   b. Distinguish wages from labor costs.
9. *a.* Review the distinction between wages and earnings.
   b. Recall the basic difference between real wages and money wages.
10. Distinguish among open shop, closed shop, and union shop.
11. Explain the check-off and maintenance of union membership.
12. Make out a case for or against the open shop.
13. Is there a place for the company union? If so, what and why? If not, why not?
14. *a.* Explain white lists and black lists. Defend or condemn.
    b. Explain fair lists and unfair lists. Defend or condemn.
15. Defend or criticize the following:
    a. Restriction of output
    b. Limitation of apprentices
    c. Professional certification
16. Can collective bargaining raise real wages in general? If so, how? If not, why not?

Topics for Investigation

1. Theories of wages.
2. Unions and minimum-wage legislation.
3. Initiation fees and entrance requirements of unions.
4. Fraternal and benefit features of unions.
5. Educational programs of unions.
6. Consumers' leagues.
7. Familiar and unfamiliar union labels.
8. Tenets of Marx on position of labor under capitalism.
9. Conspiracy doctrine as applied to unions.
10. Financial incentives and premium plans.

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See also Selected References in other chapters of Part Nine.

CHAPTER XXXIII

INDUSTRIAL CONFLICT AND INDUSTRIAL PEACE

33–1. Nature of Strikes and Lockouts. The U. S. Bureau of Labor Statistics, which keeps a record of industrial disputes, has defined a strike as "a concerted withdrawal from work by a part or all of the employees of an establishment, or several establishments, to enforce a demand on the part of the employees." The counterweapon to the walkout by employees is the lockout by employers. Both are manifestations of industrial unrest, expressing conflict instead of cooperation. In contrast, a shutdown represents industrial inactivity due to general economic conditions outside the plant.

The causes of strikes and lockouts are similar. Their result is the same; namely, a cessation of production and the creation of unemployment. In the former case, the initiative is taken by the workers; in the latter case, by management. This distinction means little, however, for employers may be responsible for conditions productive of strikes, and employees can create situations resulting in lockouts. A thoughtful analysis of the causes of industrial or international warfare requires more complete information than merely which party to the conflict fired the first shot or made a prior declaration of war.

33–2. Antecedents of Strikes. Strikes are as old as human history. Recall the involved negotiations of Moses with Pharaoh and the resultant exodus of the Israelites from their exploitation in Egypt. The slave insurrections of ancient Rome and the peasant revolts in medieval Europe were mass movements of the proletariat against property and privilege. Hence, they have been regarded as the antecedents of later strikes by modern workers.

Despite their condemnation as conspiracies, strikes of craftsmen took place in Colonial America. But they were of small extent and of little significance until the industrialization of the United States after the Civil War. Serious railroad strikes in the closing decades of the past century and crippling coal miners' strikes in the early years of the present century were the opening guns of a new era of industry-wide strife.

33–3. Extent of Strikes. The period of inflation and prosperity engendered by the First World War was characterized by many strikes. The following decade of relative stability between 1921 and 1929 was one of

improved managerial policies and of comparative industrial peace. The great depression which then ensued made jobs scarce and strikes few. As a result, the number of industrial disputes decreased from a 1917 to 1919 annual average of 4,000 to a 1927 to 1932 annual average of slightly less than 1,000.

The legalization of collective bargaining under the New Deal was followed not only by an increase in union membership but also by a revival of industrial disputes. The previous peak of 4,450 strikes and lockouts, reached in 1917, was surpassed by the 1937 peak of 4,470 industrial disputes. Man-days of idleness because of strikes rose from a low level of 3 million in 1931 to a high level of 28 million in 1937, the year of sit-down strikes in the automotive industry.

During the Second World War our government enjoyed the cooperation both of unions and of companies in the prevention and settlement of industrial disputes through the tripartite War Labor Board. Strikes were few and short, mostly of the wildcat or unauthorized variety. With the achievement of victory, however, both sides could and did express their dissatisfaction with the temporary compromises made and with the enforced concessions granted under the duress of war production. The period of industrial reconversion was characterized by the removal of many price controls and by the renewal of industrial conflict. The number and extent of strikes then conducted were unprecedented. In the first two months alone of 1946, for example, there were over 40 million man-days lost thereby, as compared with a total of 35 million man-days lost by industrial disputes during the entire preceding year of 1945, or with 23 million man-days lost thereby for the entire year of 1941, or with an average annual loss thereby of less than 9 million man-days for the war years from 1942 to 1944.[1]

This postwar wave of nationwide strikes was felt in the autumn elections of 1946, which, in turn, were followed by the passage by Congress in 1947 over President Truman's veto of the previously discussed Taft-Hartley Labor Relations Act.

33–4. Success of Strikes. In periods of prosperity, and even of industrial recovery, strikes are likely to be numerous but short; whereas in periods of business depression they are apt to be fewer in number, even though they may be more serious in character. Strikes have been called growing pains of industrial progress. They are also symptoms of a disordered industrial system.

The success of a strike is difficult to appraise. There are indirect, as well as direct, results. Gains achieved must be balanced against losses sustained. The success of a strike is conditioned by the strength of the union involved, by the character of the industry concerned, and by the state of public opinion at the time.

[1] U.S. Bureau of Labor Statistics.

The success of a strike is conditioned also by the phase of the business cycle. In periods of prosperity, workers are apt to be more successful than in business depressions. Employers are more willing then to concede to the demands of their workers; they do not wish to close their plants and they may be able to pass on the additional costs of higher wages by raising the prices of their products. In periods of depression, on the contrary, employers may be on the verge of closing their plants anyhow because of a decline in orders. They find it more difficult to assume or to pass on additional costs. Indeed, they may feel that it is necessary or possible to cut wages. In such a situation, there is little difference between a walkout and a shutdown.

33–5. Kinds of Strikes. Strikes may be either positive or negative. They are said to be positive if the workers are demanding improved conditions of labor, and negative if they are striving merely to maintain existing standards. A similar distinction is made between attack strikes and defense strikes.

Strikes may be classified according to their extent, as well as according to their purpose. Thus there are local, national, and international strikes. Local strikes are those which are confined to a particular plant. National strikes affect an entire industry and are operative throughout the country. Illustrations are coal, steel, and railroad strikes. International strikes are relatively rare, although the effects of a national strike may be international.

The *general strike* involves the cessation of work in all industries. Such a drastic measure can be explained only in terms of such far-reaching objectives as the overthrow of the existing economic system. A *sympathetic strike* is the cessation of work by employees in industries other than the one in which the strike originated. It is not apt to be successful and is rarely used by trade unions belonging to the AFL. An *outlaw strike* is one conducted by a militant minority without approval of officials of the union and without support of the majority of its members. It is also called a *wildcat strike.*

33–6. Methods of Strikes. Strikes were formerly referred to as *walkouts,* for that was the technique employed. Organized dissatisfaction with conditions of employment and collective agreement to protest them were expressed by leaving the plant in a body on a given signal or at an agreed time, or by failure to report for work at the usual hour. Except for factory guards, supervisors, and a small maintenance crew the workers remained outside the plant and did not return until the strike was terminated.

The *sit-down strike,* however, employed a different technique from that of the earlier and more conservative walkout. Workers remained on the premises of their employer, where they ceased to work and refused to permit other employees to take their places. By the sit-down strike private prop-

erty of owners of factories was seized, temporarily at least, by the workers. There was always coercion and intimidation; there was frequently violence and damage. Resistance by the employer to the appropriation of his property or interference with the transportation of food and other supplies to the idle employees inside the factory was the signal for destruction.

The sit-down strike originated in France. It was introduced into America by the CIO to secure unionization of workers and compliance with their demands. The United Automobile Workers utilized the sit-down strike in 1937 against the General Motors Corporation in many of its plants about Detroit. The novelty and the success of this action produced an epidemic of sit-down strikes. Industry was threatened with economic paralysis; capital sought escape from, if not security in, private enterprise; a short but sharp business recession shook the country.

Although the illegality of the sit-down strike was apparent even to most laymen, some governmental officials were loath to commit themselves by word or deed. Those sympathetic to the sit-down strike contended that the laborers had a property right to their jobs that was just as sacred as the property right of capitalists in their machinery and factories. Finally, in 1939, the Supreme Court of the United States rendered an authoritative decision [1] that declared the sit-down strike to be illegal. Employees who engage in sit-down strikes and resist efforts of police to oust them from factories lose their status as employees and the privileges afforded them as such by the National Labor Relations Act.

The sit-down strike in the General Motors plants was followed by the *slow-down strike* in the factories of the Chrysler Motor Company. Employees did not walk out of those plants but remained at their places; they did not cease work but continued at their tasks at a slow rate of production. Proof of concerted action lay in the fact that one of several cars came through the assembly line in an unfinished condition. Because of this situation the officials of the company closed down some of their plants. Industry could not operate against sabotage in the form of the slow-down strike. Arguments against the slow-down strike are identical with those advanced against restriction of output, discussed in the preceding chapter. The student should also recall our previous discussion of the dangers of speeding up production through pace setting and the assembly line.

33–7. Causes of Strikes. Industrial disturbances, like international conflicts, have many causes; and these are frequently so blended that it is difficult to isolate a single cause or to distinguish between immediate and remote causes. The chief aims of strikes are expressed in labor's demands for an increase in wages, for a decrease in hours of work, and for a recognition of the union. Although still the chief cause of industrial disputes, the

[1] *National Labor Relations Board v. Fansteel Metallurgical Corporation*, 306 U.S. 240 (1939).

wage question is not the sole cause. There are many other union issues, such as a demand for recognition, status, or jurisdiction.

Strikes are militant, organized protests against existing industrial conditions; a high rate of labor turnover represents a passive, unorganized protest. Strikes are an indication of industrial unrest in the same way that boils are superficial symptoms of an unhealthy body. Elimination of contributory factors is even more necessary than temporary relief from these visible manifestations of distress.

The increased strength of organized labor has made the strike a formidable device. Collective bargaining is now industry-wide and not limited to particular companies; strikes, therefore, are frequently nationwide, instead of merely local in nature. The increased use and the expanded character of the strike have serious consequences, not only to labor and capital, but also to the general public. Recent strikes in key industries, such as the coal mines and public utilities, have made this problem one of great importance. Causes of strikes must be studied and an attempt made to avert them; it is also necessary to regulate strikes by the elimination of illegal methods and unsocial practices. An enlightened managerial policy is one of the best preventives of strikes.

33–8. Legality of Strikes. The legal status of unions and the right of labor to organize are now assured. Nevertheless, not all methods of collective bargaining nor all practices of labor organizations are legal.

a. Aim and Method. The legality of a strike, like that of most other human actions, depends both on its purpose and on its methods of conduct. A collective cessation of work in a peaceful manner is recognized as legal, where the aim is an improvement in the wages, hours, and working conditions of the employees concerned. On the other hand, if the primary purpose of a strike is deliberate injury to an employer or his nonunion workers, such a strike would be regarded as illegal. Moreover, a strike, to be legal, should be free from coercion and intimidation; violence is condemned and not condoned at law.

There is conflict in all labor disputes, not only of economic interests, but also of legal rights. Workers possess the right to quit work collectively when the purpose of such a strike is an improvement of working conditions. But such an act is bound to be one of implicit coercion, if not explicit intimidation. Hence it conflicts with the employer's legal right to do business and to have free and unrestricted access to the labor and commodity markets. An effective strike must necessarily injure the business of the employer against whom it is conducted. But if the injury is incidental and not malicious, and if its primary purpose is an improvement in the working conditions of the employees concerned, such a strike is not illegal.

b. State and Industry. Laws concerning the legality of strikes vary from state to state and from industry to industry. Moreover, judicial inter-

pretations have changed from time to time, as they have differed from place to place. Court decisions have been neither clear nor consistent concerning the legality of strikes, even within a particular state and a specific industry. Finally, methods of conducting strikes have changed, as this old problem has presented constantly new facets. For example, the sit-down strike and slow-down strike presented novel legal problems to administrators, legislators, and jurists accustomed to regard strikes as walkouts.

The legality of a strike depends on the industry as well as on the state in which it occurs. The essential nature of an occupation should limit the right to strike, and not merely increase its potential effectiveness. Such was the thought behind the short-lived Kansas compulsory-arbitration law. Some states have outlawed strikes by public employees and workers in public utilities. In 1947, the Federal government legislated against strikes by its employees and provided for their postponement in essential industries.

c. Responsibility and Reasonability. Although strikes may be illegal, it is difficult to prevent them. An individual possesses the right to quit work, and to compel him to continue employment against his will would be involuntary servitude. But inducing others to quit work is a different matter; the law may condemn such collective action as conspiracy. Inducing employees or agreeing with other employees to stop work is difficult to prove, however, for the cessation of labor may appear to be as spontaneous as it is sudden. In such cases, the courts have decided that the chief responsibility must fall on the agents or officers of the labor organization most directly concerned. By such rationalization a union official was sent to prison for violation of the Kansas antistrike law, which was subsequently declared unconstitutional.

Although legislative statutes and court decisions differed, there were, before the New Deal of President Roosevelt, some broad principles of agreement. By and large, those strikes directly involving wages, hours, and conditions of work were generally regarded as legal. On the other hand, strikes to gain the closed shop, strikes to eliminate the use of nonunion materials, and sympathetic strikes were frequently, but not universally, regarded as illegal. Finally, strikers should have a direct interest in their industrial dispute, comparable in some ways to an insurable interest in an insurance contract, *i.e.*, workers should not leave their own jobs because of industrial disputes in other occupations.

33–9. Strikebreaking and Picketing. *a. Significance.* Disorder and danger threaten when an employer endeavors to keep his plant running despite a strike. Formerly, he might attempt to fill the positions of strikers who had walked out with strikebreakers who were marched in to take their places. Organized labor attached the stigma "scab" to these industrial

mercenaries. They were hated more intensely, if possible, than the employers themselves, to whom they were regarded as having sold out their cause and community. Strikebreakers were often thugs, some of whom had criminal records. They were recruited by industrial agencies and sent from job to job as occasion demanded. They were housed in temporary barracks or in the plant itself, protected by armed guards who were quick on the trigger.

Strikebreakers are rarely employed today. Union sympathizers, however, have sometimes resorted to violence in efforts to organize within their own ranks hostile or indifferent workers. What are known as "goon squads" have been thrown into strike situations to terrorize those who otherwise would work. Such coercion has been used also in jurisdictional disputes and in raids by one union on another. The pressure formerly exerted on strikebreakers has recently been exercised against loyal employees who remained at work despite strike call or against those who belonged to rival unions or to no unions.

Picketing is an organized protest against an unpopular producer or the process of production by a group of people who may carry placards proclaiming the existence of an industrial dispute or of conditions regarded as unfair to the workers concerned. Strikers try to dissuade consumers from patronizing the picketed firm. They also seek to persuade employees remaining at work to join the strike. Pickets are placed near the entrances and exits of the plant; a slowly moving line may circle the entire establishment. Picketing may extend from peaceful persuasion to intimidation and violence. It may go from the borders of the plant into the houses of the workers, who may have their homes or heads damaged by unseen hands. In some recent strikes "strong-arm" men from other occupations have been imported like mercenary troops or strikebreakers, for use as pickets in industrial disputes to which they were not a party.

b. Legality. Peaceful picketing has been held to be legal and guaranteed by the constitutional right of peaceful assembly; this view was confirmed by the Clayton Act of 1914. On the other hand, intimidation and coercion have been condemned. Of course, deeds of violence, such as attempts to destroy property and efforts to terrorize employees remaining at work, are criminal acts or conspiracies. Mass picketing without these attendant evils is rare. Consequently, the courts have found it necessary to define just what picketing may include and what it must exclude.

Former Chief Justice Taft delivered an important decision of the United States Supreme Court on the subject of picketing. He pointed out that there are limits beyond which even persuasion may not go without violating the rights of others. "Persistence, importunity, following, and dogging become unjustifiable annoyance and obstruction which is likely to savor of intimidation." [1] The number of pickets that might be stationed at each

[1] *American Steel Foundries v. Tri-city Central Trades Council,* 257 U.S. 184 (1921).

point of ingress or egress was limited to one. The worker must be approached singly and not collectively in order for the element of coercion to be absent. "Appeals should not be abusive, libelous, or threatening."[1]

The laws and judicial decisions of different states on picketing are as varied as those on striking. Several states have passed laws that make mass picketing illegal. The thought behind such laws and judicial decisions is that effective picketing, *i.e.*, mass picketing, involves coercion.

33–10. Boycotts. *a. Nature and Types.* A boycott is an organized refusal to purchase or to process the goods of an obnoxious producer. It has sometimes been exercised by the public at large as a protest against high prices and monopolies. It has commonly been used by groups of workers and unions to bring a recalcitrant employer to terms.

The simple or primary boycott is a refusal by a particular group of employees to use articles produced by their employer, who is, in their judgment, unfair to workers. The secondary or compound boycott is one that involves people other than those directly interested in the particular labor dispute. When the members of a union seek to extend the boycott from their own membership to other unions and to the general public by striving to keep others, who are not parties to the dispute, from buying or using products of the boycotted firm, a secondary boycott exists.

The boycott has been used by workers as producers, as well as consumers. Union employees in one establishment, for example, have refused to fashion products from another plant in which the open shop prevailed or in which a labor dispute persisted.

The success of a boycott, like that of a strike, depends on the strength of the particular union and on the solidarity of organized labor. Both strikes and boycotts may involve many disinterested individuals; they can cause general hardship and severe financial loss. Historic boycotts were those directed against the products of the Bucks Stove and Range Company and the Loewe Hat Company. Stores in strong labor communities were forced to discontinue the products of these manufacturers; failure to comply with this temporary interdict of organized labor meant loss of general patronage on all goods carried by the local stores.

b. Legal Status of Boycotts. The legality of a boycott, like the legality of a strike, depends on its intent and on its conduct. In the absence of consistent Federal legislation on this subject, many conflicting state laws were passed. The only common agreement and widely accepted principle lay in fairly uniform court decisions that boycotts were illegal where there was a deliberate and malicious attempt to injure an employer. If an injury was incidental to the wholesome aim to improve the working conditions of those directly concerned in the industrial dispute, the boycott was generally upheld.

The manner of conduct and the scope of a boycott are also of great significance. The power to harm is greater in collective action than in the

[1] *American Steel Foundries v. Tri-city Central Trades Council,* 257 U.S. 184 (1921).

refusal of a single worker or a small group to buy or to use the goods of a hostile employer. But in order to be effective, boycotts necessitate the persuasion of third parties. Secondary boycotts, nevertheless, have been construed as conspiracies against the constitutional guaranties of liberty and property to all citizens.

If free from malicious intent and violent methods and from deliberate attempts to coerce third parties, the boycott has generally been viewed as legal. Such a boycott, however, is as rare as peaceful picketing and chivalrous warfare. The most effective boycott is the secondary boycott.

Secondary boycotts have been viewed as interferences with interstate commerce. The passage of the Sherman Act of 1890 meant that secondary boycotts might be indicted as combinations in restraint of trade. Such was the ruling in the Danbury Hatters case, in which the Supreme Court of the United States awarded the Loewe Hat Company triple damages as provided by the Sherman Act.[1] As a result of this decision, the American Federation of Labor discontinued the "We Don't Patronize" list in its official journal, for fear that such publication might be construed as an illegal secondary boycott and as a combination in restraint of trade. New Deal legislation and judicial interpretation relaxed former limitations on the boycott. The Taft-Hartley Labor Relations Act of 1947, however, again outlawed secondary boycotts.

33–11. Injunctions in Labor Disputes. An injunction is an order from a court in equity to a particular individual or to various individuals to do or to cease doing certain specified things. The judge issues the order, determines whether or not it has been disobeyed, and fixes the penalty for disobedience. Anyone who violates such a court order becomes guilty of contempt of court and may be punished summarily without trial by jury.

The injunction is designed to prevent irreparable injury to persons or property pending final determination of rights. Such cases in equity should involve only injuries for which there is no legal redress and for which there is no statutory punishment that can subsequently be inflicted. Instead of being reserved for those rare situations for which the law provided neither immediate relief nor specific penalty, the use of the injunction became common and routine. It was utilized frequently and improperly in labor disputes. Instead of specifying a particular act or acts, "blanket" injunctions were issued. Moreover, they were used to enforce, rather than to supplement, the law.

A flagrant abuse of the injunction was the one secured a generation ago by the Bucks Stove and Range Company, whose employees had been utilizing a boycott in order to unionize the workers in that plant. A court writ was secured against this boycott of the products of the Bucks Stove and Range Company on the part of "the officers of the American Federation of Labor,

[1] *Loewe v. Lawler*, 208 U.S. 274 (1908).

officers and members of affiliated unions, friends, sympathizers, counsel, conspirators, and co-conspirators." They were forbidden to refer by printed, written, or spoken words to the allegedly unfair practices of the company and even to the very existence of an industrial dispute. Such a court order prevented the circulation of the proceedings of a convention of the AFL. If literally carried out, it would have terminated many constitutional guaranties to citizens. Freedom of speech or of the press was denied when used to promote such an illegal conspiracy as a secondary boycott. As a result of the injunction issued in the Bucks Stove and Range case, Messrs. Gompers, Mitchell, and Morrison were indicted and given jail sentences for contempt of court. One of the offenses alleged against them was the "printing of the text of the injunction in the *Federationist*."[1]

Organized labor has objected to blanket injunctions and to their issuance when no emergency justifies the sacrifice of due process of law. The abuse of the injunction leads to the sacrifice of the constitutional guaranties of freedom of speech and freedom of the press. It is contended that full publicity as to working conditions is desirable and that the injunction is often used to suppress such dissemination of information. Has not a person or combination of persons the right to make public the fact that a certain firm pays low wages, works long hours, or opposes the closed shop? If an individual's business is injured, that is incidental and not malicious; the real intent is an improvement of working conditions.

33–12. Restriction of Injunctions. *a. Clayton Act.* The Clayton Act attempted to place limitations on the use of the injunction and to remove restrictions from the use of the boycott. It provided that injunctions issued by Federal courts should not prohibit stopping work, peaceful picketing, or refusing patronage, whether done singly or in concert. Moreover, a jury trial was to be allowed in contempt-of-court cases where the offense was indictable as a statutory crime. No preliminary injunction should be served without notice, unless it was evident that immediate and irreparable injury would result.

Judicial decisions interpreted the Clayton Act neither to restrict injunctions nor to extend boycotts. Even if enforced or enforceable, the restrictions on injunctions embodied in the Clayton Act applied only to Federal courts and not to state courts.

b. Norris–La Guardia Act. As a result of frequent and flagrant abuses of the injunction in labor disputes and of the failure of Supreme Court decisions to suppress or to limit these abuses, Congress passed the Norris–La Guardia Anti-injunction law of 1932. Section 4 of this law provides that no Federal court may issue an injunction to prohibit workers, singly or collectively, from ceasing or refusing to work; from becoming or remaining a member of a union, regardless of a previous promise not to affiliate there-

[1] *Gompers v. Bucks Stove and Range Company*, 221 U.S. 418 (1911).

with; from paying or withholding strike or unemployment benefits; from aiding by lawful means a person participating in a labor dispute who is involved in court action; from giving publicity to the facts of a labor dispute by advertising, speaking, or patrolling or any other method not involving fraud or violence; from assembling peacefully or organizing to act in promotion of labor interests in a labor dispute; from advising or urging without fraud or violence other persons to join with them in doing or not doing any of these acts.

c. State Laws. State legislation likewise attempted to limit injunctions and to prevent their abuse. But these efforts at first met with little success, because they were unenforceable or unconstitutional. Within more recent years, however, many states have passed laws that limit the use of injunctions and that prevent their abuse in labor disputes. Most of these state statutes were in imitation of the Norris–La Guardia Act. They were passed after the courts ruled that this Federal statute was restricted to interstate commerce and that its limitations on injunctions were applicable only to Federal courts.

Under provisions of the Wartime Labor Disputes Act, although after the cessation of hostilities, the United States government assumed control of the coal mines during an industrial crisis. A strike was called and a restraining injunction was issued in 1946. The Federal Court sustained the injunction and imposed fines on both John L. Lewis and the United Mine Workers, holding that the Norris–La Guardia restriction on injunctions did not apply to this case, in which the United States government was involved and had itself secured the injunction.

33–13. Economic and Social Losses of Industrial Conflicts. Efforts to compute the cost of industrial conflicts are as numerous and as dubious as attempts to estimate the cost of international wars. When compared with the total volume of unemployment, that due to strikes and lockouts is relatively slight, especially when "shutouts" are substituted for "shutdowns" in slack seasons. But to make the valid observation that chicken pox is less severe than smallpox is no good argument for it. The worker who wins modest gains from strikes may require a long period of higher wages to make up for the serious loss of earnings incurred thereby. Corporate profits and dividends also are cut, and prices to consumers may be raised by serious and prolonged industrial disputes.

The indirect losses of industrial conflicts are probably greater than their direct losses. The social costs of disrupted industrial relations may be heavier than their economic burdens. One of their most serious features is the disorder that often accompanies strikes and lockouts. Conservative labor leaders deplore the use of violence, which frequently acts as a boomerang and often alienates public sympathy. Revolutionary unionism, on the other hand, condones the use of open or secret force. Much of the dis-

order that accompanies strikes can be ascribed neither to employers nor to striking employees. It is the malicious mischief of restless and reckless elements in the community who have no regard for law and order.

Although labor leaders contend that troops have been employed to break strikes and to weaken unions, such measures become necessary when the civil authorities of a community are not able to cope with the local emergency. In times of grave disorder, Federal aid can be given, for the Constitution provides that a republican form of government shall be guaranteed to the individual states. Industrial conflict may result not only in a destruction of life and property, but it may also endanger, for a time, the very existence of a democratic form of government.

33–14. Need of Governmental Action. The laissez-faire philosophy was possible as long as competition prevailed, industries were small, and workers were unorganized. Such assumptions, however, are no longer tenable, for monopolies both of capital and of labor have arisen, supercorporations have grown up, and powerful unions have been formed. Rich associations of employers are now balanced by strong labor organizations. Predatory practices and militant tactics have been utilized by both sides. The economic and social costs of industrial conflicts are now so great that the general public can no longer remain a mere spectator; the consumer, a patient sufferer; or the government, a silent partner.

Industrial peace, like international peace, is imperative, if capitalism is to be preserved, and if democracy is to be saved from anarchy. Justice to all parties requires even balance and patient negotiation of disputed issues, instead of the menacing alternatives of cessation of economic production or resort to industrial warfare. Experimental programs of industrial democracy seek the channel of industrial peace between the sands of industrial anarchy on the one side and the rocks of industrial autocracy on the other.

33–15. Methods of Adjusting Industrial Disputes. The chief methods for the settlement of industrial differences are negotiation, conciliation, and trade agreements by the parties themselves; and mediation, arbitration, and investigation by competent, neutral parties. In industrial, as well as international, relations, the prevention of conflicts is even more important than their settlement after the dispute has burst into actual conflict. Hence the necessity of permanent and efficient machinery for the continuous adjustment of petty grievances before they grow into serious disputes.

a. Trade Agreements. Trade agreements are compacts as to wages, hours, recognition of the union, and general conditions of employment that are made between an employer or an association of employers and organized labor. They represent the normal functioning of collective bargaining between parties of nearly equal strength. An agreement is generally reached at a joint conference between union officials and repre-

sentatives of employers. It has a specific time limit, at the end of which another conference is held for the purpose of drawing up a new trade agreement or modifying and reaffirming an old one.

Trade agreements are statements of accepted usages or of approved conditions of employment within an industry. Individual firms and employees make employment contracts based on such trade agreements, but most trade agreements themselves are not legal contracts. It is possible, however, to strengthen trade agreements by making them into enforceable legal contracts, if the parties thereto are willing, able, and responsible.

The National Labor Relations Act of 1935, which legalized collective bargaining, forced employers to negotiate with the certified bargaining unit of the workers even though the agreement reached thereby was not enforced by penalties against unions for strikes in violation of its terms. The Taft-Hartley Act of 1947, therefore, sought to make unions, as well as employers, responsible for keeping their agreements. But a loophole in the new law was promptly found or fashioned by the coal miners, who agreed to work "as long as they were able and willing" to do so.

b. Conciliation and Mediation. The term "conciliation" is sometimes used for the settlement of industrial disputes without the interference of a third party, but the word is more often used as synonymous with mediation. Trade agreements are normal and regular, but conciliation implies the existence of a crisis or failure to reach an agreement. Mediation is the presence of an outside person or a nonpartisan body for the facilitation of industrial peace during such a labor crisis.

Conciliation and mediation are similar in that neither is compulsory nor judicial. The mediator has been termed a "confidential adviser" and an "industrial diplomat." His chief function is to help the two sides come to an agreement of their own accord rather than to render an award or a decision of his own making.

c. Industrial Arbitration. Industrial arbitration, in contrast, is more judicial than diplomatic. Arbitration involves the existence of a person, board, or court for the purpose of making an investigation and submitting a decision.

Arbitration may be either voluntary or compulsory, and the acceptance of the award may be either voluntary or compulsory. Thus four combinations are possible, namely, (1) voluntary arbitration with voluntary acceptance of the award, which is really no more than mediation; (2) voluntary arbitration with compulsory acceptance of the award, which is commonly known as "voluntary arbitration"; (3) compulsory arbitration with voluntary acceptance of the award, which is, in effect, compulsory investigation; and (4) compulsory arbitration with compulsory acceptance of the award, which is commonly known as "compulsory arbitration."

TABLE 24. CROSS CLASSIFICATION OF METHODS OF ADJUSTING INDUSTRIAL DISPUTES

Acceptance of award	Initiation of action	
	Voluntary	Compulsory
Voluntary	Mediation	Compulsory investigation
Compulsory	Voluntary arbitration	Compulsory arbitration

d. Compulsory Investigation. Compulsory investigation means an impartial study of the causes of an industrial dispute. "More light without more heat" is the slogan. A public statement of the findings will rest the case with the great jury of public opinion. The temporary suspension of the right to strike, which is sometimes involved, results in the postponement of industrial warfare and possibly in its elimination.

Compulsory investigation relies on the weapon of public opinion instead of legal compulsion. Strikes and lockouts cannot always be prevented, but they can be delayed until an impartial commission makes an investigation and publishes its findings. Meanwhile, the passions of opposing parties have cooled, and the facts in the case have been ascertained and disseminated. Such a procedure permits the crystallization of an intelligent public opinion, which cannot be defied with impunity either by labor or by capital. Table 24 shows methods of adjusting industrial disputes.

33-16. Types of Governmental Action. Various attempts by government to adjust industrial disputes may be grouped as mediation, voluntary arbitration, compulsory investigation, and compulsory arbitration. Great Britain, the Federal government of the United States, and most individual states of the Union have utilized mediation and voluntary arbitration. Great Britain and several European countries have employed compulsory investigation, some with and others without postponement of the right to strike. Postponement of strikes with prior notification and prompt investigation has been in effect in certain basic industries in Ontario, Canada, and in Colorado and other American states. It was incorporated in the Labor-Management Relations Act of 1947. Compulsory arbitration, formerly used in Australasia and Kansas, has been abandoned.

33-17. Governmental Arbitration and Investigation Compared. The various steps in voluntary arbitration have been outlined as follows:

(1) The submission of the dispute to the decision of a third party; (2) submission to an investigation; (3) refraining from a strike or lockout pending investigation;

(4) drawing up an award; (5) enforcement of the award and refraining from strike or lockout during its life. Arbitration remains strictly voluntary even if at every step except the first the state uses its compulsory power. The essential thing is that *both* parties consent in advance to calling in the powers of government. Hence, it is not inconsistent with the idea of voluntary arbitration for the state to use its power of compelling testimony, or even of enforcing an award, provided that both sides have previously agreed that this is to be done.[1]

Under compulsory investigation, however, the state may step in on the initiative of either party without the consent of the other, or on its own initiative without the consent of either party directly affected by the labor dispute. The state board of investigation is empowered to summon witnesses and to exact testimony, but it is purely a fact-finding organization. Although it may recommend as well as investigate, the board is without legal power to enforce its award. The compulsory postponement of strikes and lockouts during investigation is highly desirable, but it is not essential to compulsory investigation.

Compulsory arbitration results when the government compels employers and employees to submit their labor disputes to an independent body and an outside agency for a decision. In compulsory arbitration, all five steps listed for voluntary arbitration are followed, but the first step is no longer optional. Moreover, coercion exists all along the line; the dispute must be submitted to arbitration and the parties must refrain from strikes and lockouts. Witnesses must testify, the board must make a decision, and the parties to the dispute must observe the award during the period specified in the decision.

33–18. Mediation and Arbitration Compared. The chief advantage of mediation is that it helps the disputants to solve their own problems. A mutual understanding or a voluntary agreement between the two parties is better than an award imposed by an outside body of arbitrators. A governmental commission of mediators accomplishes a great forward step merely by bringing together the two disputants. Discussion of their chief differences develops a knowledge of "the other fellow's point of view." A sympathetic understanding of points of agreement and disagreement may develop a way out of the difficulty through the formulation and acceptance of some workable formula. Mediation makes for negotiation, and negotiation makes possible a mutual agreement, which is apt to work better and to last longer than an award of impartial but uninformed arbitrators, who may reach a compromise pleasing to neither side.

Arbitration and mediation are different stages rather than different methods. After mediation has been tried unsuccessfully, the two parties may agree to submit their differences to an impartial board of arbitration. The volun-

[1] Commons, J. R., and J. B. Andrews, "Principles of Labor Legislation," 4th ed., p. 137, Harper & Brothers, New York, 1936.

tary arbitration of industrial disputes, as well as of international disputes, is far superior to the costly methods of fighting them out to the bitter end.

It is alleged that an outside board of arbitration cannot be familiar with existing conditions and with the problems at issue. In order to obviate this disadvantage, representatives of both employers and employees may be placed on the board of arbitration in addition to representatives of the general public. In such a tripartite body, the votes of the first two groups generally are assured in advance; the ultimate decision rests, as before, with representatives of the public. Such was the method followed by the War Labor Board. The American Arbitration Association, on the contrary, generally functions through a single arbitrator, chosen from its list and accepted by both sides.

33–19. Advantages and Disadvantages of Coercion. Advocates of compulsory arbitration point out that mediation, voluntary arbitration, and compulsory investigation do not always eliminate industrial conflicts. Compulsory arbitration, therefore, is defended as a necessary final resort. In our complex and interdependent, modern civilization, strikes, lockouts, boycotts, and other weapons of industrial warfare injure countless individuals who are not parties to those disputes. In its final analysis, the case for compulsory arbitration rests on the public welfare, which is jeopardized by such industrial conflicts.

On the other hand, there are strong arguments against coercion by the government. The existence of a powerful board of arbitration, whose award is compulsory, implies the existence of certain standards of justice. But judgment may be rendered on the basis of expediency and experience, rather than on some abstract principle. The determination of a just wage is even more difficult than the determination of a minimum wage. The regulation of prices is a dubious and difficult function of government. The judicial method of using precedents, if followed, is detrimental to progressive wage standards; if not followed, there is danger of discrimination, or at least of discrepancy in awards.

The enforcement of unpopular decisions is always undesirable and often impossible; individuals cannot be compelled to work against their wills. Most of the verdicts of courts of compulsory arbitration in Australasia and Kansas were favorable to labor. Nevertheless, the cry of favoritism and prejudice was raised by the workers when a case went against them. Employees also have opposed wage boards, because they regulate conditions of employment and prescribe rates of wages. Ultraconservatism of capitalists or radicalism of laborers is frequently claimed by the defeated litigant; an improper extension of the functions of government is charged by implacable foes of compulsory arbitration.

The constitutionality of compulsory arbitration is a moot question in the United States. It has been indicted by extremists as a restriction on

the constitutional guaranty of freedom of contract and as an imposition of conditions of involuntary servitude. Judicial opinion in the United States condemns compulsory arbitration as a general principle, although it may condone it in basic industries and during war emergencies.

Organized labor has attacked compulsory arbitration because of the limitations that it imposes on the weapons of collective bargaining. The right of organized labor to strike is jeopardized or sacrificed. Unions are weakened, for some of the chief reasons for their existence are destroyed.

33–20. Implications of Compulsory Arbitration. The very essence of conciliation, mediation, and voluntary arbitration is the voluntary acquiescence in and mutual participation by employers and employees. The power of collective bargaining of neither party is sacrificed. But compulsory arbitration is coercive, as it restricts the bargaining power of both labor and capital.

The workers contend that the loss of the lockout to the employer is not so serious as the loss of the walkout to organized labor. The employer is not forced to shut down his plant in order to cut wages, but the workers may be forced to strike, or to threaten such a move, in order to raise or to maintain their wages. A strike is essentially the collective refusal of an employer's terms by his organized employees. The loss of the right to strike weakens or destroys labor's power to bargain collectively over terms and to negotiate successfully for favorable agreements.

Under compulsory arbitration, the power of employers to bargain effectively must be reduced proportionately to that of employees. Labor's loss of the right to strike must be balanced by the employer's loss of power to change wages, hours, and conditions of employment without advance notice and subsequent investigation. Such provisions are far more effective than mere refusal of the right to lockout. An employer could easily substitute a shutdown of his plant for a lockout by claiming that it was unprofitable to continue operations under existing conditions.

If compulsory arbitration is to be substituted for collective negotiation, the state must assume the duty of regulating wages, hours, and working conditions. Governmental officials or bureaus, such as wage-and-hour boards, must establish and enforce not merely minimum wages and maximum hours in general, but also standard wages and hours in particular industries and localities, recognizing and relating competitive differentials. Moreover, the enforcement of such awards must be accomplished without a shutting down of the plant by a strike or lockout and without a slowing down of production to a rate that makes it unprofitable for the employer to continue in business.

Guide Questions on Text

1. *a.* Distinguish between primary and secondary boycotts.
   b. Discuss the legality of the boycott.
2. *a.* What is an injunction? What is its purpose?
   b. Defend its use in labor disputes, if you can do so.
   c. Show how injunctions have been and can be abused.
3. *a.* Define a strike.
   b. Distinguish it from a lockout and a shutdown.
4. *a.* Outline common causes of strikes.
   b. Which seem of increasing and of decreasing importance? Why?
5. *a.* Roughly indicate the rise and fall in the number of industrial disputes. How do you explain their wide variation?
   b. When are strikes most numerous and why?
   c. When are they most successful and why?
6. *a.* Distinguish among walkout, sit-down, and slow-down strikes.
   b. Which of these, if any, would you defend as legitimate? Why?
7. *a.* What are the chief factors determining the legality of strikes?
   b. Show how the legality of some practices has varied.
8. *a.* How can mass picketing be peaceful persuasion?
   b. Discuss the legality of picketing.
9. Show the economic and social costs of industrial disputes.
10. *a.* Indicate the essential differences between mediation and arbitration.
    b. Show the relative advantages and disadvantages of each.
11. Distinguish carefully between voluntary and compulsory arbitration. Wherein are they similar and dissimilar?
12. *a.* Distinguish between compulsory investigation and both mediation and arbitration.
    b. Show the advantages and limitations of compulsory investigation.
13. *a.* Justify or criticize the legal compulsion to postpone strikes in essential industries.
    b. Indicate safeguards and limitations on such compulsion.
14. *a.* Justify or criticize compulsory arbitration.
    b. What has experience with it demonstrated?
15. *a.* What are the distinctive features of trade agreements as the products of collective negotiation?
    b. Should they be enforceable at law as binding contracts on the two parties with penalties for violation? If not, why not? If so, how?

Topics for Investigation

1. Jurisdictional strikes.
2. Activities of business agents of unions.
3. Sympathetic strikes and general strikes.
4. Governmental machinery for better industrial relations in your own state.
5. Promotion of industrial peace during the First and Second World Wars.
6. *a.* Compulsory arbitration in Australasia.
   b. Kansas Court of Industrial Relations.
7. Compulsory arbitration and organized labor.
8. Compulsory investigation in essential industries.

9. Trade agreements in the coal mines.
10. Industrial relations in the clothing industry.
11. National Labor Relations Board; its functions and methods.
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See also Selected References in previous chapters of Part Nine.

CHAPTER XXXIV

INDUSTRIAL PATERNALISM AND INDUSTRIAL DEMOCRACY

34–1. Employers' Approach to Industrial Maladjustments. Economic problems of importance include unemployment and industrial conflict, previously treated, and excessive labor turnover, to be discussed presently. Management has sought to solve these problems by programs of industrial paternalism, including scientific management of industry, personnel administration, and welfare work, and by programs of industrial democracy, including employee representation and profit sharing. Industrial paternalism has been called benevolent despotism in industry, because the employer is dominant therein even though he may be very considerate of his workers. In so-called "industrial democracy," however, the employer is willing to share either the control or the product of industry, or both, with his workers.

Having sketched the labor programs of the state through legislation and those of unions through collective bargaining, we shall now survey the employers' programs of industrial paternalism and industrial democracy. Chart 22 shows the three related aspects of industrial paternalism:

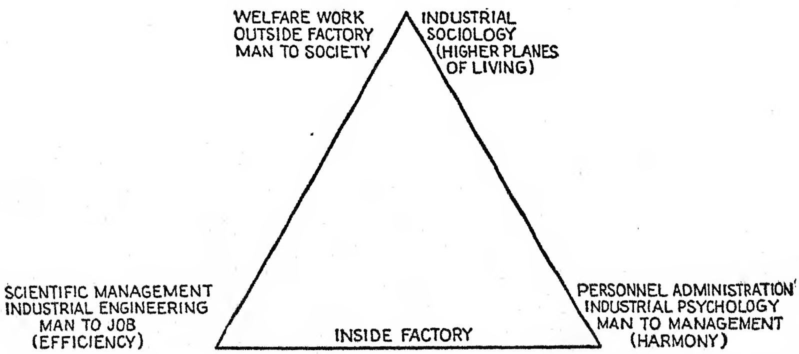

CHART 22. Triangle of industrial paternalism or benevolent despotism in industry.

(1) scientific management or industrial engineering, which is devoted primarily to the relations of the workers to their jobs with the object of increased efficiency therein; (2) personnel administration or industrial psychology, which is especially concerned with the relations of men to manage-

ment with the aim of improved harmony within the business organization; and (3) welfare work or industrial sociology, which goes outside the walls of the factory into the homes of the workers in the hope of improving their ways of living as well as their ways of getting a living.

34–2. Labor Turnover. *a. Nature.* "Labor turnover" is the technical term for what is popularly known as hiring and firing within industry. It is change of personnel within a business organization.

Unemployment means no work, but labor turnover means change of work. Although there may have been no stoppage of production within a particular industry, locality, or period, such continuity of employment does not imply that the same people have held the same jobs. Individuals may have been irregularly employed and may have gone from one position to another. Although the stream of employment may have flowed continuously and evenly, its human composition of particular workers in specific positions may have altered frequently and greatly.

Labor turnover is generally expressed as a ratio between the number of people employed and the number of positions existing in an organization. For example, an annual labor turnover of 300 per cent would signify that during this year, on an average, three people were employed for every position in the plant. Although some employees remained constantly at their posts, many more individuals changed their positions from one firm to another.

b. Social Significance. Studies have shown that an annual labor turnover from 200 to 400 per cent has not been unusual, even in ordinary times. In periods of readjustment, such as those to and from national-defense industries, labor turnover has been far greater. Hence this problem may be as serious as that of unemployment. Moreover, unemployment or irregular employment can exist along with excessive labor turnover. Their social aspects in industrial inefficiency, economic waste, and human costs are similar.

Labor turnover has social significance also as a reflection of industrial unrest. People express their dissatisfaction with working conditions passively and individually by quitting their jobs, as well as actively and collectively by walking out on strikes.

c. Forms of Labor Turnover. Labor turnover may be any one of three types: a general layoff of all workers, a discharge of some employees, and a voluntary quitting of others. Although it is difficult to classify every separation of an individual from his job, most studies of the problem seem to indicate that the third type of labor turnover is greater than the other two types combined. The relative proportion of these different types of labor turnover varies in periods of depression and periods of prosperity. During periods of depression, the relative proportion of layoffs is greater; but in periods of prosperity, the relative proportion of voluntary separations is greater.

d. Causes. The causes of labor turnover, like those of poverty, may be approached from either the individual or the environmental aspect. Among the personal causes of excessive labor turnover are such factors as illness, a migratory tendency, or an uncongenial disposition. Within the environment are such economic and social factors as those which contribute to the general problem of unemployment previously considered.

An important cause of excessive labor turnover is the absence of a sound personnel policy or the presence of glaring weaknesses in industrial management. Poor methods of hiring and placing workers, autocratic management of industry, lack of financial or nonfinancial incentives to increased production and permanency of position, presence of unfavorable working conditions, absence of recreational facilities, and lack of vocational education are other direct or contributory causes of excessive labor turnover.

Skill and sex also are important factors in this problem. The rate of labor turnover is higher for unskilled workers than for skilled workers. Perhaps the superior organization of skilled workers makes it possible for them to shape somewhat better their conditions of work and to hold more securely their places of employment. The common laborer may be discharged with impunity, for his place is easily filled; he can express his dissatisfaction with his job only by quitting work, after which he must blindly look around for other employment. Labor turnover is less among women than among men in spite of the common assumption that women are merely loaned to industry.

e. Effects. A certain mobility of labor is necessary to permit competition among employers to smooth out wage irregularities in different industries and to improve general working conditions. Some change of occupation is desirable for men seeking to improve their positions and to rise from one labor group into another. But much labor turnover is a mere change in personnel and an exchange of jobs without accomplishing these objectives.

The effects of excessive hiring and firing both on the individual worker and on industry in general are similar to those of unemployment and industrial conflict. The laborer may lose as many working days because of a frequent change of jobs as because of a long shutdown of the plant; he is apt to lose more time because of labor turnover than because of strikes or lockouts. Our previous discussion of the effects of unemployment and of industrial conflict makes unnecessary a lengthy treatment of the effects of excessive labor turnover. It will be sufficient to note here that labor turnover causes industrial inefficiency, which, in turn, causes a still greater labor turnover. The frequent changing of jobs with intervals of idleness between them is demoralizing to the individual worker, because it destroys steady habits of thrift and industry.

Stability of personnel is a vital factor in efficient production. Excessive hiring and firing is wasteful and expensive. The cost of breaking in a new

employee varies in different industries, but it has been estimated at from $25 to $100 for ordinary semiskilled labor. Consequently, excessive labor turnover causes a tremendous drain and a severe strain on the industry in which it flourishes.

f. Reduction of Labor Turnover. The mitigation of labor turnover, like the reduction of unemployment and the prevention of industrial conflict, is an important problem of industrial management. Its serious social aspects likewise are ameliorated by a more enlightened policy of management, such as the establishment of personnel departments and the installation of pension systems.

Between the First and Second World Wars considerable reduction of labor turnover, if not of unemployment, was achieved. This was due, in part, to the enlightened policy of management and, in part, to changed economic conditions. Good jobs were not easy to obtain in the industrial reorganization that followed the First World War. In the period between 1921 and 1929, the volume of employment did not keep pace with that of production. In the depression from 1929 to 1933, unemployment was rampant and a job was something to be held as long as possible. With industrial recovery in the early thirties, industrial conflict in the middle thirties, and industrial rearmament in the late thirties, the problem of labor turnover became aggravated. It was increased by Industrial Reconversion for the Second World War and industrial reconversion thereafter, although such flexibility and mobility of labor were then essential.

34–3. Scientific Management. *a. Nature.* Scientific management is an attempt to apply the experimental method to industry and to measure results. It may be viewed as a later phase of the industrial revolution, which, in turn, grew out of the still earlier "age of enlightenment." Scientific management represents a further advance in technology, *i.e.*, in the application of science to the problems of economic production. The material aspect of modern technology is power machinery; its nonmaterial aspect is improvement in industrial processes.

Scientific management seeks to discover by objective investigation what method of doing a particular piece of work is most efficient; *i.e.*, which yields the maximum of production with the minimum of effort or waste, after which the industrial process or business organization is standardized in accordance with the approved technique. Scientific management compares its results with those of traditional methods; it discards guesswork and "rule of thumb" in favor of "the best by test."

b. Pioneer Studies. The father of scientific management was Frederick Taylor, who may justly be given the title of "the first efficiency engineer." He became interested in the subject because of his observation of the common tendency of workmen under modern conditions to shirk or "to soldier on the job." Taylor ascribed this tendency to ignorance on the part of

both employers and employees as to what constituted a fair day's work. He sought to determine this standard in concrete cases by the process of scientific experimentation.

In order to secure a fair day's work with maximum production, it was necessary to investigate, to improve, and to standardize industrial processes. It was no longer possible to leave to the workman the details of how he should work. Taylor's famous time studies led him to the conclusion that many laboring operations were inefficient, but that most of them were capable of improvement by experimentation and standardization.

c. Essentials of Scientific Management. Scientific management requires a carefully laid out plant to facilitate the smooth, continuous, and rapid flow of work. It involves the introduction of improved machinery and the use of the most efficient industrial processes. Scientific management schedules carefully the work of each laborer and every machine.

Another essential is the transfer of function, direction, and method from workers to management. Ordinary and repetitive operations are separated from exceptional work. The latter is the function of management or of specially trained workers, whose time should not be spent on routine matters needing little skill or judgment. This increase in the functions of management assumes especially prepared assistants or "functional foremen."

Scientific management requires also the keeping of careful records, the implications of which should be analyzed and utilized. Cost accounting is necessary to the better control of industry.

After improving the general conditions of work and raising labor to a high point of efficiency, a standard day's work is generally decided on for a specific operation. A scaled bonus above the current wage rate may be given to a worker who finishes his task in less than the allotted time.

d. Accomplishments and Potentialities. Numerous illustrations could be cited to show how the introduction of scientific management resulted in greater production. For example, astonishing improvement was made thereby even in the simple and repetitive occupation of bricklaying. After training workers in better methods, an average of 350 bricks per man-hour was achieved in one experiment instead of the former average of 120 bricks per man-hour by the same workers.

The advantages of scientific management, like those of machinery, with which it is often associated, should accrue to the employee and to society in general, as well as to the employer who introduces it. Technological progress, of which scientific management is an important phase, increases production and, consequently, real income. It will result in higher planes of living and greater leisure time, unless its gains are frustrated by restriction of production or concentrated in the greater profits of management. Scientific management can be expressed in higher wages, shorter hours, and lower prices.

Professor Irving Fisher summarized the case for scientific management as follows:

> As an economist I would stress particularly the value of scientific management to labor. When, as a matter of course, scientific management is as universal as the telephone or newspaper, I have little doubt that the welfare of labor will be double; in short that real wages will be twice as high as at present. In the end, labor gains the most from so-called "labor saving devices." Increased production means simply increased income to society, and the wage earner as a class usually profits the most in the end.[1]

e. Objectives and Objections. Scientific management has two objectives. The first consists of the systematization of industry by the introduction of improved and standardized methods of production. It separates managerial functions from laboring operations, handwork from brain work, and skilled labor from unskilled. The second objective is psychological rather than technological, for it consists of devices designed to stimulate the worker to increased production. The second objective of scientific management is difficult to separate from the first, but it is the chief source of opposition on the part of labor.

Efficiency has been defined as maximum output with minimum effort. Scientific management has stressed the first factor but often ignored the latter. Moreover, workers resent being treated as automatons; they rebel against being driven to the limits of their physical and mental capacity. Maximum production from a machine differs from maximum production from a human being.

f. Opposition of Labor. The chief objection of the worker to scientific management comes from his fear that it is merely a ruse of the employer to speed up his employees to their utmost exertion. The worker is frequently obsessed with the familiar lump-of-labor fallacy; he fears that scientific management will rapidly lessen the total volume of work to be done and thus increase unemployment.

Organized labor also regards scientific management as a subtle attempt of employers to weaken labor organizations. Again, its primary aim—increased production—is the very opposite of the union's policy of limitation of output. These opposing objectives of management and organized labor revive the questions whether a fair day's work is the same for all workers, and, if so, whether it can be determined either by the trade union or by the efficiency engineer. Human differences are such that any leveling-up or leveling-down process may work individual hardship and cause injustice.

Some spokesmen for organized labor further object that scientific management tends to reduce the mass of workers to the ranks of semiskilled automatons who must take detailed orders from managerial supervisors.

[1] Irving Fisher, in an address delivered Dec. 4, 1924, before the Taylor Society.

This so-called "functional arrangement" is as autocratic as the former "military" organization of industry. Scientific management is viewed as undemocratic also because of the temptation to fit men to their jobs, rather than to place men in jobs for which they are best fitted by nature and previous training.

In the last place, the complex character of modern industry makes it difficult for a worker to see the direct benefits to himself of improved methods in industry. He contends that, in the division of the gains of scientific management, the employer has received the lion's share. He fails to visualize the general diffusion of its indirect benefits in the form of lowered prices for the many commodities that he himself purchases. The worker can see only that under scientific management he suffers increased mental and physical strain without compensating gain in the form of a shorter working day. Slightly higher wages are little compensation for a shortening of his working life and an early dismissal to the human scrap heap of industry.

34-4. Personnel Administration. *a. Nature and Aims.* Scientific management has been supplemented by personnel administration, which has been defined as the "direction and coordination of human relations of any organization with a view to getting the maximum production with a minimum of effort and friction, and with proper regard for the genuine well-being of the workers." [1]

The time studies of early scientific management made the mistake of viewing industrial relationships as mechanical, rather than as psychological. Personnel administration added industrial psychology to industrial engineering; it supplemented the economic ideal of efficient working with the social ideal of happy, harmonious living. It broadened the scope of management from relations between the worker and his job to relations between the worker and his employer. It extended the interest of management from working conditions of employees to their living conditions.

The triple concern of personnel administration then is the improvement of relations between the worker and his work, between the worker and his fellow employees, and between the worker and his employer. The best technical processes and the most scientific methods in industry will not reach their full fruition if the human element is ignored. Unhealthy, maladjusted, and discontented employees are less efficient than healthy, harmonious, and happy employees.

Personnel administration seeks to improve general working conditions of a plant so that the health, comfort, and safety of its workers can be advanced. It seeks to reduce excessive labor turnover by a more careful selection, placement, and education of workers. It also strives to eliminate

[1] Tead, O., and H. C. Metcalf, "Personnel Administration," p. 2, McGraw-Hill Book Company, Inc., New York, 1920.

friction between men and management and to promote better industrial relations. Finally, personnel departments usually supervise welfare programs among employees.

b. Services of Personnel Departments. Personnel administrators first make job analyses of various positions within a particular plant, and then draw up careful specifications concerning the personal and technical qualities necessary for the successful performance of each occupation. With such a check sheet before him, the personnel officer can examine the specific skills and techniques and the general mental, physical, and moral qualities of each applicant, as revealed by an oral interview, a written examination, a practical test, and a careful scrutiny of references. Such an examination reduces excessive labor turnover by a careful selection of employees. Again, it seeks to prevent dissatisfaction and industrial unrest by a proper placement of the employees selected.

The discharge and promotion of workers were formerly as arbitrary as their methods of employment and placement were unsatisfactory. A good worker might be dismissed summarily because of some minor personal fault and even because of a whim, prejudice, or grudge of his foreman. It is true that discipline and cooperation must be maintained, if efficiency is to be promoted and waste reduced. Foremen, plant guards, and other supervisors must be supported by the management that hires them, but power of discharge should not be absolute and immediate.

The personnel department should supervise promotions as well as dismissals. Industrial unrest results and individual grievances arise not only from unwarranted dismissals, but also from unmerited advances. The personnel department in cooperation with its production departments should seek to formulate not only job analyses but also standards for measuring efficiency of workers. Performance records should be maintained and consulted. Rating schemes are easy targets for criticism, both by men and management, but they are serviceable and capable of improvement and extension. Even imperfect rating methods are a step toward objectivity; they are probably better than no method at all except personal favor or mere chance.

Transfers within a plant are another important function of the personnel department. An employee may be a misfit rather than a total failure. Before being discharged as incompetent, he might well be tried at another kind of work within the same firm. Such a worker would come to feel that management is interested in his individual welfare and that big business is not utterly impersonal. By such activities the personnel department can develop an *esprit de corps* and a loyalty to the organization, which may be expressed in increased production and decreased waste, both elemental tests of its success.

The personnel department also performs educational work in the aims and processes of its industry. To selected applicants it may give intro-

ductory courses to show the nature of particular occupations involved and to promote efficiency and interest in their prospective jobs. Such industrial training also helps the individual worker to visualize the relationship of his particular task to the industry as a whole. It may reduce thereby the stultifying character of specialized production; it may increase the occupational flexibility and mobility of labor.

Unlike the older type of scientific management, which widened the gulf between men and management, modern personnel administration tries to close it by improved human relationships. Industrial morale is regarded as vital to industrial efficiency. Individual grievances, if discovered and discussed, may be eliminated or ameliorated instead of smoldering in discontent and perhaps later bursting into the flames of disorder.

c. *Organization of Personnel Work.* As conditions vary greatly in different places, no standard plan of organization can be given that would be applicable to all types of personnel work. Moreover, the human element is ever present in people, whether men or women, employees or employers. In the final analysis, the best plan of personnel administration is the one that produces the best results for a particular group of people working under a particular set of conditions. Although such a statement is too vague to be useful, there are certain principles of personnel administration that have stood the test of experience even though not capable of universal applicability. Although details of administration should be elastic, it is important that responsibility be centered in a specially trained official or in a definitely established personnel department. To go into further discussion of the controversial principles of personnel administration would be beyond the scope of this text; they are less definite than those of scientific management just outlined.

Subdivisions or committees of a personnel department depend on the nature and extent of its work as well as on the character of the industry and community. In addition to the fundamental functions of employment, placement, promotion, transfer, and dismissal, there may be divisions on industrial relations, individual grievances, health, safety, welfare, and education. Its functions are almost as indefinite and infinite as those of the public relations department, although it is clear that the latter is concerned with relations of the firm to people outside and not inside the industrial family or corporate unit. Each calls for special training and exceptional personal qualities of judgment, tact, and patience.

Close contact must be maintained with men and management, in order to get the point of view of both sides on a given matter. No project should be undertaken without first understanding and then explaining its objectives. Knowledge and sympathy are essential to the success of all plans of the personnel department. A mediocre scheme that emanates from suggestions of the workers may fare better than a superior device superimposed on them. Committees of the workers themselves are neces-

sary for the successful administration of such welfare programs as the personnel department may see fit to develop. Personnel work is educational as well as social; care should be exercised not to expand until the ground is carefully prepared.

34–5. Welfare Work. *a. Nature and Scope.* The extension of the functions of management beyond the factory walls into the leisure time of the workers has been termed "welfare work." It has been defined by Professor Commons to include "all those services which any employer may render to his work people over and above the payment of wages."

The first stimulus to welfare work came from the employment of women and children within factories and mercantile establishments, but it later spread to other groups of workers. It also went from industry to the home, and from working conditions to living conditions. The concept of the functions of management and the concern of the employer have widened far beyond increased and improved industrial production. Management is now regarded as having social, as well as economic, responsibilities.

Various welfare schemes that have been developed include housing, recreation, education, health, safety, and thrift projects. They are generally operated under the personnel department, usually by joint committees representing both employers and employees. They are sometimes accompanied by schemes for profit sharing and industrial representation by employees.

b. Housing Projects. Because of the isolated location of many of its mines and furnaces, the Colorado Fuel and Iron Company inaugurated housing projects for its employees. Although early company towns like that of Pullman, Illinois, were rather drab, later ventures had beauty as well as utility. For example, Hershey, Pennsylvania, known as the "chocolate town" contains useful community buildings and beautiful public parks, which the Hershey Company has provided for its inhabitants, most of whom work in that industry. It has also constructed attractive homes, which it rents to its employees, and a magnificent hotel, which is open to guests.

c. Recreational Schemes. Some employers are as reluctant to inaugurate recreational programs for their employees as to enter upon housing projects. They have often preferred to subsidize these projects and to leave their operation to a community organization. The industrial branch of the Young Men's Christian Association, for illustration, has cooperated very effectively with men and management in this respect. Witness the numerous branches of that and kindred organizations that have been established in great railroad and industrial centers.

Most large companies have provided rest rooms; some have organized recreational facilities for their employees. Baseball, basketball, and bowling contests are held among such firms and among different departments within a large company.

It is important that these recreational activities of workers be administered by their own representatives. Some contribution from all participants will engender a feeling of independence. It is also desirable that the recreational facilities be near to, but not inside, the factory.

d. Social Service. Many large firms maintain social-service departments, while others subsidize existing social agencies for use by their own employees. The latter method is perhaps preferable to the former, because it avoids a multiplication of existing social organizations and because it eliminates the criticism that the employer is prying into the private affairs of his employees. The workers themselves may organize permanent or temporary committees to visit the sick and to help restore unfortunates to economic independence. Such a program may be subsidized and supervised by the personnel department. In special cases, a visiting nurse or a trained social worker may be found helpful.

e. Thrift Programs. Other welfare projects seek the promotion of thrift. They include Christmas or vacation funds, opportunities to buy the stock of the company on favorable terms, and saving and loan associations for the purchase of homes. Profit sharing will be treated later.

Many companies have their own pension systems by which they reward the long and faithful services of their employees. The welfare programs of some firms also include the maintenance of disability funds for the care of the sick, injured, widowed, and orphaned members of their large industrial families. Such benefit plans give financial assistance in time of need, encourage thrift among the workers, develop a fraternal spirit among them, reduce labor turnover, and tend to induce loyalty to the company on the part of its employees.

f. Advantages and Disadvantages of Welfare Work. Welfare programs should be developed gradually. They should be expanded only as rapidly as sentiment among the workers seems to warrant. As far as possible the employees themselves should manage, or participate in the management of, the detailed operation of these projects.

If wisely directed and democratically administered, welfare work should produce cooperation, rather than antagonism, on the part of employees toward their employers. Instead of creating resentment among the workers against management's intrusion into their methods of living and its interference with their leisure time, welfare work can be made to breed contentment and loyalty to the "corporation with a soul."

Organized labor, nevertheless, has not taken a very sympathetic attitude toward the welfare work of management. It has been stigmatized as "capitalistic feudalism" or as "benevolent despotism" that merely increases the dependence of employees on their employer. The workers sometimes resent attempts to influence the ways in which they spend their leisure time. It is further charged that welfare work has often been given, not in addition

to wages, but rather in lieu of wages, *i.e.*, as a substitute for higher compensation.

Organized labor has insisted that the workers be given a greater share in the product of their labor and that they be permitted to spend it as they please. It is felt that the paternalistic schemes of some employers reduce their workers from the high level of free men to that of "wards of capitalism." In the last place, it is contended that many elaborate welfare schemes have been inaugurated not for humanitarian reasons but to advertise the products of employers and to build up their commercial asset of good will.

The advocates of welfare work point out in rebuttal that the low planes of living of many families of workers are due not only to inadequate earnings, but also to the fact that their wages are not spent wisely. Higher standards of living are conditioned not only by more efficient production, but also by more economical consumption.

Welfare schemes can give to the workers the benefits of large-scale production and wholesale purchases. The company store or corporation home should be able to sell or rent the employee a better product for the same money. Only in rare cases is compulsion exercised on the worker to induce him to buy at the company store or to live in a company house. This is necessary only when the plant is located in some new section on the frontier of civilization. In most cases, the workers are free to choose for themselves.

34–6. Political and Industrial Democracy. The much used and often abused term "democracy" has many interpretations. For our present purpose it will be understood to mean participation in control by many, instead of autocratic control by one person or concentrated control in the hands of a few people. Democracy is a relative term and a progressive concept, like standard of living, because the ideal progresses as society approaches it.

Not only has the democratic ideal been rising, but it has also been moving over from political to industrial relationships. The worker as a citizen enjoys the right of suffrage, although the political machine has sometimes perverted democracy into corruption or concentration. But, conversely, the citizen as a worker has rarely had a similar privilege of voting for the officers and policies of the industry in which he has worked. Instead he has generally been a mere cog in the gears, or a soldier in the ranks taking orders from his superior officers. Within recent years, however, the military or old-line organization of industry has been giving way before a functional organization, previously discussed in this chapter, under personnel administration; it has also been succumbing to a more democratic organization, now to be presented.

The success of democracy is conditioned by the education of a people. Accustomed to autocracy, the German people merely replaced a hereditary emperor by an elected dictator. "Benevolent despots" in industry

have been submerged by the rising tide of democracy. The new deal of the copartnership of labor and capital has arisen above the waves of industrial disorder. Its preservation and success, however, are likewise conditioned by the spread of public education among the masses and by the development of intelligent leadership in industry. Otherwise captains of industry may similarly be replaced by equally autocratic labor bosses.

34–7. Industrial Representation. *a. Nature and Types.* Industrial representation is participation by workers in the control of their working conditions. It is representative government in industry. This modern economic ideal is embodied in such organizations as shop committees, works councils, and industrial congresses. It is expressed by collective negotiation through trade unions or industrial unions. Company unions are apt to be paternalistic and dominated by the employer; welfare work may be substituted for collective bargaining between two parties of nearly equal strength. Independent but irresponsible unions, on the other hand, can be coerced by labor barons, in which event they degenerate into the industrial feudalism of rival bosses and predatory gangs. In both cases there is domination, but not democracy.

Industrial representation can be achieved either cooperatively with organized labor or independently of organized labor. Trade agreements are made for many occupations in the joint conferences of employers and unions. On the other hand, industrial representation has been achieved within company unions that embrace only the employees of individual firms. Industrial representation by and through trade unions has been common in Europe and Australasia, but employee representation by and through company unions was popular in the United States before the passage in 1935 of the National Labor Relations Act.

b. Aims. The primary purpose of industrial representation is the reduction of dissatisfaction and unrest through closer and better relationships between labor and capital. Its aim is not merely the elimination of strikes and other industrial conflicts, but also the promotion of better mutual understanding. Works councils and industrial parliaments serve as peaceful mills for the rubbing away of friction points between employers and employees, lest they burst into the flames of open conflict or smolder in secret discontent. Organizations for industrial representation serve also as agencies of education in the problems and points of view of opposing sides in our present industrial alignment. Better mutual understandings, in turn, promote industrial good will and greater efficiency in production. Although sometimes prompted by practical and even selfish motives, industrial representation is essentially an expression of the new democratic ideal of copartnership in industry.

c. Development in the United States. Industrial representation, at least until recently, had not been so extensive in this country as in Europe, particularly in Great Britain and Germany. It was limited here to the works

councils of individual firms or the collective bargaining of strong unions. It had not developed as abroad into district and even national parliaments of industry, except for the joint conferences of some highly unionized occupations, such as coal mining.

Moreover, industrial representation in this country had expressed itself in different and hostile forms, namely, trade unionism, industrial unionism, and company unionism. Employee representation within the United States had developed apart from the organized labor movement, rather than in connection with it. The impetus toward employee representation, *i.e.*, company unionism, had come neither from government nor from labor, but from management. Its development was aided by the schism within the labor movement between trade unionism and industrial unionism.

Employee representation developed on this side of the Atlantic from what was regarded as the dubious experiments of a relatively few liberal employers. It later established itself as a means of adjusting grievances between men and management. Still later, employers found it to be a means of promoting efficiency and a method of providing for the general welfare of their employees. Finally, employee representation or company unionism was found by management to be a preferable form of industrial representation to that of trade unionism or industrial unionism. Consequently, company unions under employer guidance or supervision were fostered as a substitute for or a preventive of independent unions. This was especially true after the legalization of collective bargaining in the National Industrial Recovery Act of 1933 and before imposition of restrictions on company unions in 1935 by the National Labor Relations Act.

d. Breach between Company and National Unions. Works councils express industrial representation through the business organization, rather than by craft or industry. They represent the workers as employees of particular plants through company unions. The walking delegate or business agent is not an employee and hence is ineligible for representation in works councils.

Such a definition of works councils as employee representation through company unions is a narrow but accurate description of the situation in the United States. In Great Britain and other countries, however, works councils are frequently organized in conjunction with the existing machinery of trade unionism. In the United States they developed apart from and still remain apart from organized labor.

Trade unions and industrial unions are forms of industrial representation but not of employee representation. Collective negotiation for trade agreements between organized labor and associations of employers is between organizations whose bargaining power is relatively strong and nearly equal. Hence this form of labor representation is perhaps fairer than that of company unions, in which the employees have little bargaining power.

These great industrial parliaments that formulate trade agreements are more typical of democracy—at its best and at its worst—than are company unions, which typify industrial paternalism or benevolent despotism. Works councils represent industrial government of employees, often for employees, but rarely by employees.

34–8. Rise and Fall of Company Unions. *a. In the Prosperous Twenties.* Following the First World War, company unionism grew rapidly in the United States. According to a survey by the National Industrial Conference Board, the number of companies with employee-representation plans in operation more than doubled from 1919 to 1922 and just about tripled from 1919 to 1926. But from 1926 to 1928, and again from 1928 to 1932, a decline took place in the number of companies with employee-representation plans in effect. The number of workers covered by employee representation, however, increased rapidly and steadily, rising from about 400,000 in 1919 to 1,241,000 in 1924, and to 1,548,000 in 1928. This decline in number of companies, accompanied by an increase in number of workers covered, between 1926 and 1928, is accounted for by the fact that, although many small companies abandoned employee representation between these years, their places were taken by a smaller number of large companies, which employed more workers under employee-representation plans than had been previously so employed by a larger number of small companies.[1]

b. In Depression of Early Thirties. The depression years saw a reduction both in the number of companies having plans of employee representation and in the number of workers covered. Nevertheless, the decline in membership in company unions was probably no greater than, if as great as, the decline in trade-union membership. Again, the improved status of collective bargaining under the National Industrial Recovery Act of 1933 stimulated a renewed interest in company unionism in spite of the prohibition of coercion and the elimination of yellow-dog contracts. There was a similar revival of trade unionism with a subsequent development of industrial unionism.

c. Company Unionism under the New Deal. Immediately following enactment of the National Industrial Recovery Act in June, 1933, the number of company unions and the membership therein increased rapidly. Another study [2] by the National Industrial Conference Board of some 650 companies having employee-representation plans involving about a million workers revealed in November, 1933, that over three-fifths of these plans had been established within a few months following the passage of the National Industrial Recovery Act. The number of employee-representa-

[1] National Industrial Conference Board, "Collective Bargaining through Employee Representation," 1933.

[2] The National Industrial Conference Board, "Individual and Collective Bargaining under the N.I.R.A.," 1933.

tion plans and membership therein continued to grow rapidly. In April, 1935, membership in company unions was estimated [1] at 2,500,000 workers, a figure rivaling membership in trade unions.

The National Labor Relations Act of 1935 reaffirmed the right of workers to bargain collectively through representatives of their own choosing. It set up administration machinery to hold secret elections among the workers to determine the desired agency to represent them and to hear complaints by the workers of infringement by employers of their right to bargain collectively. Finally, severe penalties were imposed on employers who intimidated employees from joining national unions or who enticed employees into joining company unions. Employee representation through works councils was not outlawed, but employers were forbidden to subsidize company unions or to influence their policies. Members of company unions were not to be given special favors, and members of national unions were not to be treated with discrimination. The result of this legislation was a decrease in the number, the membership, and the power of company unions.

34–9. Evaluation of Company Unions. *a. Objectives.* The chief aim of employee representation is the promotion of industrial good will through a better understanding of men by management and of management by men. It facilitates personal contact, where the firm is engaged in programs of health and safety or in comprehensive welfare projects.

The chief objective of management in furthering employee representation is to promote industrial efficiency and economy of production. Again, it tends to minimize the likelihood of strikes, sabotage, and other forms of industrial conflict or retaliation. In brief, management has come to feel that a contented employee, as well as a healthy one, is more efficient and productive than a discontented or unhealthy worker.

Employee representation gives workers an opportunity to present their grievances to the management in a more direct but less effective manner than through unions. Works councils may also be agencies for interpreting decisions and for enforcing awards. They may formulate industrial standards to improve working conditions.

b. Results. The effects of employee representation are difficult to determine, for the movement has been recent, brief, and controversial. Most statements of its results are at variance, as recounted by management and by organized labor. Again, the success of employee representation has varied from time to time, from place to place, from industry to industry, and from employer to employer. In general, these expressions of results are modified statements of the objectives of the program, as stated in the last section.

[1] Bernheim, A. L., and others, "Labor and Government," The Twentieth Century Fund, Inc., New York, 1935.

c. Criticisms by Workers. Organized labor has looked askance at company unions; it has insisted that labor must work out its own salvation through its own organization and by its own weapons of collective bargaining, such as the strike and the boycott. Industrial conflict is sometimes the necessary price of victory; industrial harmony is often the easy road to loss of power by unions and loss of privilege by workers.

The American Federation of Labor has formulated its objections to company unions or plant systems of collective bargaining. The charges of unfair elections and of intimidation of representatives have been made. It has been contended that company representatives have attempted to divert attention of workers from the real objects of collective bargaining into such items as safety-first movements and educational programs for increased efficiency and greater production. Again, company unions have been regarded as lacking in power and in danger of becoming subservient implements of employers' associations. Behind these arguments lurked the great fear that the whole organized labor movement would be weakened. Many of these arguments were revived and some of them were revised to support inclusion of anti-company-union features in the National Labor Relations Act, which strengthened industrial representation through independent unions and which weakened employee representation through company unions.

d. Attitude of Employers. Many employers have opposed industrial representation, and even employee representation, but for different reasons. They have insisted on their individual right to run their own businesses in their own way. Consequently, they have resented attempts of their employees to dictate or to pry into what they considered their own affairs. Other employers have been sympathetic toward participation by workers in the control of industry but skeptical of labor's ability to do this in an intelligent fashion.

The legalization of collective bargaining by the National Industrial Recovery Act of 1933 intensified the struggle between independent unions and company unions. Leaders of organized labor renewed their criticisms of works councils, formulated shortly after the First World War. On the other hand, spokesmen for employers' associations were less severe in their criticisms of employee representation because they regarded it as preferable to other forms of industrial representation. After the legality of collective bargaining had been assured, company unions were viewed as a lesser evil than the old danger of trade unions and the new menace of industrial unions.

34–10. Participation of Workers in Profits. *a. Relation to Other Aims of Labor.* Greater participation in the product, as well as in the control, of industry is an aim of the labor movement. Hence wider distribution of profits, as well as greater democracy of management, has been sought by

many employees and provided by some employers. Profit-sharing schemes have supplemented plans of employee representation and programs of welfare work.

Although labor has attempted through collective bargaining to increase the share of national income going to wages, it has been unable or unwilling to participate in the financial risks of industry. Although demands for increased wages have emanated from the workers, schemes of profit sharing have generally come from employers.

b. Nature and Objectives of Profit Sharing. Profit sharing may be defined as a method of industrial remuneration by which the employee receives in addition to his regular wage a definite share, fixed in advance, of the profits of the business. Thus profit sharing does not eliminate the wage system, but exists with it as an extra financial inducement to increased production or to decreased waste.

In addition to this objective of increased efficiency, profit sharing has been regarded as a means of reducing labor turnover. It has been introduced by some socially minded employers for the reduction of industrial unrest. On the other hand, profit sharing, like employee representation, welfare work, and pension plans, has been introduced also for advertising purposes. Finally, it has been favored by management as a method of strengthening company unionism at the expense of trade unionism.

c. Types of Profit Sharing. Profit sharing takes many different forms, but they fall into three general groups. In the first place, profit sharing may be done through a cash distribution of profits. At the expiration of a definite period of time, profits are computed in a manner formerly decided on and then distributed to the workers as cash bonuses. In the second place, profit sharing may take the form of a distribution of shares of stock in the company. In the third place, profit sharing may take the form of pensions, annuities, or other types of deferred savings.

Profit-sharing schemes may be classified also according to the degree to which they approximate true profit sharing. Many so-called "profit-sharing" schemes represent merely the payment of a bonus in times of prosperity without precise effort to make it conform to net profits and without promise of repetition under similar circumstances. The sliding scale is not an accurate method of profit sharing, even though it is definite and repetitive; the profits shared with the workers vary with the price of the product, not with the net profits of the business organization.

d. Contrast with Gain Sharing. Profit sharing treats the workers as a group or as a number of groups. The total profit is divided among the total number of workers according to some accurate or rough measure. It makes no effort to determine what contribution to profits has been made by the individual worker and to reward him accordingly. Gain sharing, on the other hand, has this very objective. As under piecework, the individual

worker is rewarded according to his individual productivity. Although the worker is paid by his time, rather than at a piece rate, his individual productivity is measured. Any excess beyond a previously determined fair rate is correspondingly rewarded out of the profits of the firm. Gain sharing is associated with scientific management; profit sharing is related to the cooperative movement.

e. Limitations of Profit Sharing. To what extent does profit sharing accomplish its objectives? Unlike gain sharing, profit sharing does not reward the individual worker in proportion to his superior or increased productivity. Hence its effectiveness as an industrial stimulus is questionable. The relationship between increased exertion and increased profit on the part of the individual worker is not direct. It assumes a social consciousness and an industrial *esprit de corps* that is often lacking. On the other hand, if it succeeds in developing these valuable qualities, profit sharing is desirable. If it fosters sympathy and mutual regard for the importance of labor, business enterprise, and invested capital, it is of economic service.

Experience has shown that profit sharing may produce contention instead of cooperation. Profits are often reduced by changes in demand and other influences beyond the control of management or worker. Although production may have been carried on more efficiently than ever before, losses rather than profits sometimes stare the enterpriser in the face. Are the workers ready to share these risks of industry? The elimination of the enterpriser will not eliminate his functions as the shock absorber of modern economic society.

f. Criticisms by Labor. Organized labor has criticized profit sharing, just as it has opposed employee representation. It has charged that the fair market rate of wages or the full marginal product of labor has not been paid where cash bonuses were distributed to make up the difference. Labor prefers a high and definite rate of wages to participation in profits.

Moreover, labor leaders view such attempts of employers as efforts to weaken labor organizations and to disarm them of their weapons of collective bargaining. To these alone the workers must look for increased wages and improved conditions. Although schemes of deferred profit sharing appeal to the employer as clever devices for reducing labor turnover and industrial unrest, they undermine the independence of the worker and check the mobility of labor. At best, they are regarded by organized labor as the paternalism of some well-intentioned employers.

g. Experience with Profit Sharing. The practical test of survival also can be applied to profit sharing. In both Great Britain and the United States, such schemes have shown a high rate of mortality. About one-half of the early profit-sharing enterprises were subsequently abandoned. The sequel to this story is recent experience with employee ownership of stock, which was popular before 1929 but unpopular during the years of de-

pression that followed. Such a record seems to reveal a fundamental weakness not only in this particular form of profit sharing but also in the general movement.

It should be remembered, however, that the proportion of ordinary business failures is so great that it is remarkable how many people fly in the face of statistics and engage in business for themselves. Again, little progress would be made if it were not for ambitious individuals who are constantly snatching success from failure. The history of all inventions, discoveries, and business ventures is strewn with failure.

Profit sharing is a desirable but dubious economic experiment, which has been successful only with leaders of sufficient vision, tact, and executive ability. But these few triumphs prevent us from feeling that too much social and individual effort has been expended in this cooperative and constructive attempt to solve the vital industrial problems of distribution and incentives.

Guide Questions on Text

1. *a.* Define each and distinguish between industrial paternalism and industrial democracy.
   b. Give examples of each.
   c. Criticize our use of these terms. Can you suggest better and more appropriate terms for these concepts?
2. *a.* Define labor turnover and show how it is measured.
   b. Outline its various types.
   c. Show its economic and social significance.
3. *a.* State central purpose and essential features of scientific management in industry.
   b. Explain and evaluate labor's criticism of it.
4. *a.* What are the chief concerns and services of personnel administration?
   b. Illustrate important activities.
5. *a.* Define welfare work. Criticize definition.
   b. Why is welfare work done by industry? Should it be?
   c. Why is welfare work opposed by unions? Is their attitude fair?
6. *a.* How are scientific management, personnel administration, and welfare work related as a comprehensive program of the employer?
   b. How can they be differentiated and separated?
7. *a.* Distinguish among craft, industry, and company forms of industrial representation.
   b. Which do you favor and why?
   c. Is one form incompatible with another? Why or why not?
8. *a.* Indicate important differences in the development of industrial democracy in Europe and the United States.
   b. Suggest reasons for these differences.
9. *a.* How is profit sharing related to industrial representation? Why so?
   b. Is effective use of one possible without the other? Why? How?
10. *a.* Formulate a satisfactory definition of profit sharing.
    b. Does profit sharing eliminate the enterpriser or the wage system?

11. *a.* Outline types of profit sharing.
b. Which seem fairest, and which seem most practical? Why?

12. *a.* What are the reasons commonly given for the frequent failure of profit sharing? Do they seem sound and complete?
b. What general and particular conditions seem essential to the success of profit sharing? Why?

Topics for Investigation

1. Taylor as a pioneer in scientific management.
2. Modifications of early scientific management.
3. Time and motion studies.
4. Organization and activities of the personnel department of some business organization with which you are familiar or which you can study.
5. Welfare projects of some particular industry.
6. Works committees and industrial councils in England.
7. Nature and success of early plans of industrial representation in the United States.
8. Organization and activity of some company union with which you are familiar or which you can study.
9. Development of company unionism in the United States.
10. Sliding scale of profit sharing.
11. Experience with employee ownership of stock.
12. Proposal of a guaranteed annual wage for industrial workers.

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Part Ten

WORLD PROBLEMS OF ECONOMIC REORGANIZATION

CHAPTER XXXV

THE COOPERATIVE MOVEMENT

35–1. Cooperatives and Corporations under Capitalism. Works councils and profit sharing provide for the copartnership of labor and management, but the cooperative movement would dispense altogether with the enterpriser. A business would be run, not by an individual proprietor, nor by a corporation organized for profits, but cooperatively, *i.e.*, by a representative committee of workers or consumers. Profits would be divided among workers or consumers according to some previously arranged plan, instead of being appropriated by the individual enterpriser or given to corporate stockholders. In a cooperative, there is only one vote per person; with ordinary business corporations there is one vote per share of stock.

The primary objective of a truly cooperative movement is the substitution of mutual benefit for private gain. Its immediate aims are the reduction of the economic wastes of our competitive system and the elimination of middlemen and individual employers. Its ultimate aim is the evolution of a cooperative commonwealth. Although such an objective may be revolutionary, its methods of attainment are peaceful and lawful. Moreover, the process is viewed as a gradual one of education in voluntary association. Cooperatives can and do exist under the capitalistic system.

35–2. Cooperative Movement and Socialism. State socialism is political and bureaucratic; it is superimposed from above. The cooperative movement, on the contrary, is more economic than political in character. It is a group, rather than a national, experiment. Cooperative associations can grow up naturally and locally within our present economic society. They can demonstrate their merit or lack of merit in comparison with the existing competitive and individualistic system. Indeed, a cooperative association has been regarded as socialism within the test tube or as a pilot plant of socialism.

The status of private-property rights, however, is different under the two systems. The cooperative movement recognizes not only the importance of capital, but also the propriety of private-property rights in producers' goods. Cooperatives pay interest on borrowed capital and a fixed dividend on invested capital. Socialism, in contrast, would limit private property to a modest amount of consumers' goods and to as much producers' capital as a single individual working for himself could employ. Any "unearned income" is viewed with suspicion.

35-3. Types of Cooperation. The cooperative movement has many phases. Thus there are consumers' cooperatives, producers' cooperatives, and distributors' cooperatives. There are cooperative organizations for the sale of goods, for the purchase of goods, and for the finance of commodities or services. There are agricultural cooperatives for the farmer, and housing cooperatives for city workers. Finally, there are combinations of these functions and compromises between cooperation and competition.

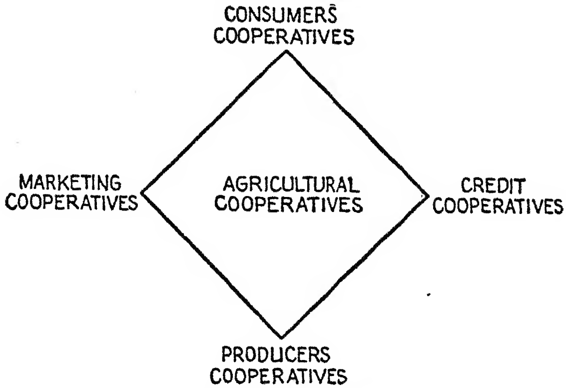

CHART 23. Types of cooperatives.

There are also many commercial enterprises claiming to be cooperative in character that are not true cooperatives, as we have just defined them.

Consumers' cooperation is represented by cooperative stores, which, in turn, may be subdivided into wholesale and retail cooperatives. Cooperative retail stores divide refunds among their members according to their purchases. Cooperative wholesale stores do the same for their own members, which are cooperative retail shops in Great Britain but often individual enterprises in this country.

Producers' cooperation is represented by factories, owned and operated by the workers; profits are appropriated by the workers themselves.

Distributors' cooperation might more properly be called marketing cooperation. It seeks to reduce the wastes of our present system of distributing goods by a more intelligent and mutually helpful coordination of effort. It would eliminate the middleman and the commission merchant; it would distribute their profits to growers of the produce.

Cooperative credit associations include credit unions, savings and loan societies, mutual savings banks, and mutual life-insurance companies.

Agricultural cooperation is a composite type, which includes all of these forms of cooperation.

These types of cooperation are illustrated in Chart 23.

35-4. Consumers' Cooperation. *a. Rochdale Pioneers.* Consumers' cooperation dates from the famous Rochdale cooperative store, which was

opened in 1844 by a score of humble English flannel weavers in an effort to combat high costs of living. The capital was subscribed by prospective purchasers who lived in the vicinity. Shares of stock, which had a par value of £1 each, could be purchased by individuals in moderate circumstances; a fixed return of 5 per cent was specified. An old building on a side street was rented; the total sales for the first week amounted to only a few pounds. Such was the modest beginning of the most successful and familiar plan of cooperation.

The general policy followed was that of charging current market prices for articles sold at the cooperative store; profits were not placed in the market basket. A purchase check, stating the amount, was given every buyer after his cash purchase. Net profits after costs of operation, including a modest fixed return on capital investment, were divided, not among stockholders in proportion to shares of stock held, but among members according to the amount of purchases made during the last quarter. Profits were secured because of the economy of collective buying at wholesale rates. Losses from uncollected accounts were eliminated by a cash-payment policy. Services were limited to mere merchandising without advertisement or delivery. Goods carried in stock were staple articles of good quality. Full publicity was given to financial records, a simplified statement of which was available to all members.

A unique feature of the Rochdale plan was its democratic form of management. Every stockholder possessed only one vote, and not one vote for every share of stock held. Wide participation in the benefits of the cooperative store resulted from the provision that a prospective member need make an initial cash payment of only one shilling, or one-twentieth of the par value of a share of stock, and then contribute the remainder in part payments out of his share of profits earned. Nonmembers might buy at cooperative stores, but a share in profits was contingent on membership.

b. Development in Great Britain. The Rochdale plan was a success from its very beginning. Other cooperative stores, imitating its fundamental features, soon developed. England now has hundreds of retail cooperative stores, which do an annual business of several hundred million pounds and have millions of members.

The English Cooperative Wholesale Society was founded in 1864, for the purpose of collective buying for its cooperative member retail stores. Its object was the absorption of the profits of individual jobbers and wholesalers. Profits of this cooperative wholesale society were distributed among its member retail stores in proportion to their respective purchases.

Finally, cooperative wholesale societies began to manufacture and to grow certain products for themselves, instead of continuing to buy them from profit-making producers. The English Cooperative Wholesale Society is now the largest flour miller and the largest biscuit manufacturer

in Great Britain. It is engaged also in the manufacture of clothing, furniture, and numerous other articles. It maintains iron works and coal mines in England, tea plantations in far-distant Ceylon. Its own merchant fleet carries its products from one part of the globe to another.

c. Advantages and Limitations of Consumers' Cooperation. The greatest achievements of consumers' cooperation have been the promotion of thrift and the reduction in costs of living. They have been accomplished by the group absorption of individual profits and through a greater standardization of consumers' goods. In addition to these economic advantages of increased economy and decreased waste, there are important social gains, such as the substitution of cooperation for competition and the promotion of the ideal of mutual benefit instead of that of individual gain.

Cooperative societies conduct their productive enterprises just like any other business corporation, with the qualifications just indicated. They strive to maintain good working conditions and to pay their employees fair wages, but their workers do not necessarily possess industrial representation or a voice in management. Employees of consumers' cooperative societies do not ordinarily share in profits except in so far as their purchases there warrant.

d. Consumers' Cooperation in Europe and the United States. The cooperative movement spread from England to Scotland, Wales, and Ireland, and from Great Britain to the continent of Europe, where it was especially significant and successful in the Scandinavian countries. The movement has been fortunate in the type of men who have assumed its leadership.

Within the United States, consumers' cooperation has lagged. Several explanations have been suggested. As American wages have been higher than those of Europe, economic pressure toward thrift and economy has been less severe here than abroad. Moreover, it is alleged that the American is an individualist, not interested in cooperative movements. Again, retail stores are very attractive in this country; their variety delights the American consumer, who may be less willing than the English consumer to standardize his consumption. Finally, the relative mobility of labor and the heterogeneous character of our industrial population may have been obstacles to the development of the cooperative movement in America.

Whatever the causes may be, the fact remains that cooperative stores neither prospered nor proliferated in the United States. Although a number of profit-making private enterprises have posed as cooperative stores, they have been cooperative in name only. They have used this slogan for the purpose of increasing sales by alleged purchaser discounts or trading-stamp devices.

On the other hand, this country has experienced the development of chain stores, department stores, and mail-order houses. Because of the economies of large-scale purchase and large-scale management, such or-

ganizations have frequently been able to undersell small retailers by cutting prices. Americans have patronized such stores lavishly, under the immediate stimulus of taking their profits in the market basket.

e. Cooperative Wholesale Associations in the United States. At present, cooperation or extinction seems to be the choice of independent neighborhood stores in the large cities of the United States. Consequently, many wholesale cooperative associations have come into existence. Some of them have had a lengthy and successful history. The most noteworthy are organizations of retail druggists and grocers, who found it necessary to organize in order to protect themselves against the competition of chain stores.

The specific purpose of these cooperative associations is to permit the small retail druggist or grocer to enjoy the economy of purchasing in large quantities, which appears to be the chief advantage of chain stores. These retail merchants are individual enterprisers in business for profit and in competition with each other. Nevertheless, their wholesale organizations are cooperative, for profits are divided among members according to their respective purchases.

35–5. Producers' Cooperation. *a. Compared with Consumers' Cooperation.* Producers' cooperation is sometimes associated with consumers' cooperation, but the two schemes are very different. Although the former is older than the latter, it has not met with the same success. Consumers' cooperatives strive to purchase cheaply and to lower costs of living, whereas producers' cooperatives seek to raise wages and to improve working conditions. Consumers' cooperatives divide the profits of enterprises among consumers, whereas producers' cooperatives divide them among the workers. Consumers' cooperatives provide economy, whereas producers' cooperatives promote industrial democracy.

Both producers' and consumers' cooperation are similar in that they substitute collective action for individual initiative; each would eliminate the enterpriser. Moreover, both plans are based on representation by individuals instead of shares of stock owned. One man, one vote, is the general principle of all cooperative enterprises.

b. Development of Producers' Cooperation. Producers' cooperation, like profit sharing, originated in France. The revolution of 1848 gave a stimulus to self-governing workshops; but the movement was a general failure, or rather the original idea of Louis Blanc was never fairly applied. Producers' cooperation was attempted also by Robert Owen at New Lanarck in Scotland. His innovations aroused great interest, but the results were few and temporary.

c. Difficulties of Producers' Cooperation. The repeated failures of producers' cooperation have been explained in terms of various obstacles and objections. Chief among them is the difficulty of securing adequate capital. Workmen's savings are a meager source from which to draw, and the

capitalist is not apt to lend funds to an enterprise of which he doubts both the desirability and the practicability.

Another difficulty is lack of managerial ability. Workers are not always good businessmen, for the successful enterpriser is a combination of natural ability, acquired education, and commercial experience. Workers have often failed to realize the importance of business enterprise to successful production; consequently they have rarely offered sufficient reward to attract capable managers. Numerous cooperative schemes, headed by honest but inexperienced individuals, have failed because of their lack of competent and seasoned generalship.

On the other hand, where producers' cooperation has been successful, there has frequently been a subsequent and perhaps a consequent reluctance to permit other workers to enter that organization on equal terms with those workers who made it successful. The capitalization of past successes and undistributed profits by veteran members generally terminates the experiment in producers' cooperation. The result is a corporation with hired employees, some of whom own shares of stock while others do not. When the principle of one man, one vote, yields to that of one share of stock, one vote, the organization has ceased to be cooperative in the strict sense of the word.

Producers' cooperation thus has been continuously menaced either by the failure of an unsuccessful venture or by the capitalization of a successful one. In general, it has succeeded better in small establishments, requiring skilled craftsmen but little capital, than in large plants, requiring abundant capital but unskilled labor. The existence of a relatively stable demand for the product is another element favorable to the success of producers' cooperation.

35–6. Agricultural Cooperation. *a. Buying and Borrowing.* Farmers have long cooperated with each other in building barns and harvesting crops; but the development of capitalistic agriculture has necessitated ever greater cooperation. Machinery is often too expensive for one farmer to purchase by himself, especially if it is not to be used continuously. Mutual associations of farmers, therefore, may buy such machinery and then rent it to their members at low rates. The local creamery also is often a cooperative venture of neighboring dairy farmers.

Cooperative purchasing likewise plays an important part in agricultural cooperation. These purchases consist largely of feed, fuel, containers, building materials, seed, fertilizer, machinery, tools, and other articles in common use by the farmer. The low cost of handling these goods for distribution by cooperative purchasing agencies has been in striking contrast to the substantial mark-up of dealers.

Another need of the American farmer has been cheap credit on loans secured by agricultural collateral. The Federal Farm Loan or Rural Credits

Act permitted the organization of joint-stock land banks and farm-loan associations. The latter are cooperative societies somewhat similar to urban saving and loan societies or credit unions. More recent developments were treated in an earlier chapter on agricultural problems.

b. Marketing Cooperatives. The most important phase of agricultural cooperation is that of marketing. Farmers' products require transportation and storage; they also must be sorted, graded, packed, and sold. These numerous important services have been performed by commission merchants and also by agents of marketing cooperatives. In either case efficient marketing is essential to prevent destruction or deterioration.

Fruits and vegetables are now cooperatively marketed in many places. Some of these agricultural cooperatives are local and serve mainly neighboring markets. Such is the Cooperative Society of Hammonton, New Jersey, which for many years has shipped various kinds of berries to Philadelphia and other cities.

There are also larger cooperatives, whose markets are continental in scope. For example, several California organizations market various kinds of fruit all over the United States and Canada. These large cooperative distributing agencies may be federations of small local cooperatives, such as the California Fruit Growers' Exchange, or centralized organizations, such as the Sun Maid Raisin Growers. The Florida Citrus Exchange is a rival concern, similar in organization and purpose, that also does a national business, but on a somewhat smaller scale. The Northwestern states also market by distributors' cooperatives their apples, pears, and other fruits.

Cotton farmers suffered from inadequate marketing facilities and from inordinately low prices. Cooperatives, therefore, were organized for ginning and marketing cotton. State organizations were preferred to a centralized sectional organization for the entire cotton-growing area. These cooperatives had some success, but they were unable to achieve stabilization of price. Their power was limited by the fact that they controlled only a small portion of the large cotton crop.

Wheat producers in the Northwest, like cotton growers in the South, suffered similarly from inadequate marketing facilities and from serious declines in the price of grain. Granger movements developed voluntary marketing cooperatives. These organizations included cooperative grain elevators—or warehouses for storing wheat—and producer-controlled cooperative selling agencies with state or regional pools for stabilizing the price of wheat. As with cotton, grain price stabilization was difficult.

35–7. Credit Unions. Cooperative credit societies developed in Germany about the middle of the last century. They took the form of small unincorporated associations of farmers or tradesmen who pooled their meager individual savings. Loans therefrom might be made to other members for carefully supervised purposes. Rates of interest were cheaper

than those charged by commercial banks, for most officers served without compensation and the expense of elaborate offices was avoided.

Similar credit unions, the American name for credit cooperatives, have been common and successful also in this country among such groups of workers as railroad and postal employees. Small loans are made from the funds of the association, which come chiefly from the subscriptions of members to the stock of the credit union. Although collateral is not generally required, these loans are carefully supervised and each applicant for a loan must be endorsed by several fellow-members. The interest charges of these credit unions have been less than those charged by loan companies organized for profit, to which the poor man without collateral would otherwise have been forced to resort. The interest so collected goes back into the funds of the cooperative credit union for other small loans.

35–8. Savings and Loan Societies. The first building and loan association in America was founded in Frankford (now a part of Philadelphia) in 1831. Its purpose was to encourage thrift and home ownership by providing a society into which members could regularly and safely deposit savings, and from which they could easily and economically borrow funds for the purchase or improvement of their own homes.

After a century of community service, many building and loan associations collapsed; their members suffered severe losses during the depression years from 1929 to 1933. Consequently, the Roosevelt administration reorganized mortgage banking for home as well as farm. Cooperative Federal savings and loan associations came into existence for the promotion of thrift and home ownership. Funds deposited therein were guaranteed up to a modest sum in a manner comparable to deposits in commercial banks. Home Owners' Loan Banks were created to coordinate, to supervise, and to extend credit to member savings and loan associations, just as Federal reserve banks do to member commercial banks.

35–9. Mutual Savings Banks. Savings banks developed as institutions to promote thrift and to enable workers safely to invest their small earnings. The first savings bank in America was instituted in New York in 1816 after an English model. Early savings banks were cooperative in the sense that they were mutual. There was no capital stock, and deposits constituted the entire source of loanable funds. Profits were proportionately divided among depositors. Later mutual savings banks had capital stock but paid the stockholders a fixed rate of return and divided net profits in excess of this amount and general operating expenses among their depositors.

35–10. Mutual Insurance Companies. Insurance represents both thrift and protection. It is the workers' chief bulwark against industrial insecurity and the risks of everyday life.

Most life-insurance companies and some property-insurance companies are mutual; *i.e.*, policyholders become stockholders automatically. Even

when operated for profit, the very nature of insurance is cooperative, for it is a diffusion of risk. Insured individuals, who do not suffer loss or hardship, compensate, financially at least, those who do. If the insurance company is mutualized or profit sharing, it is even more cooperative in character, for profits in excess of costs of operation, payment of benefits, and reserve requirements are prorated to policyholders or deducted from their premiums. Most beneficial associations are cooperative societies, but they have often ignored the basic principle of "old-line" insurance by failing to provide adequate reserves for their contingent liabilities. Insurance has been more fully discussed in two previous chapters devoted to business and social insurance.

35-11. Reserve Provisions. Like all business concerns, cooperatives should set aside a portion of their earnings as reserves for tax liabilities, bad debts, possible operating deficits, inventory losses, depreciation and obsolescence of equipment, and as sinking funds for the repayment of bonded indebtedness. Failure to allow sufficiently out of profits for the noninsurable uncertainties of business and to convert insurable risks into definite costs of production by the periodic payment of insurance premiums gives a false impression of financial success by exaggerating profits and concealing losses or liabilities. The result is sudden collapse in a severe business crisis or slow but sure failure over years of operation.

For this reason certain states require that all cooperatives (whose membership is widely distributed among low-income groups) set aside a portion of their earnings as reserves for contingencies. It is commonly stipulated that 10 per cent of net earnings be so segregated until the reserve aggregates 30 per cent of the total capitalization of the particular cooperative. In the case of insurance companies and banks, as we have seen, special reserve requirements have been enforced by both state and Federal governments.

35-12. Taxation Features. It has been alleged that cooperatives enjoy tax-exemption privileges not afforded ordinary business corporations. In contrast, chain stores, so it is argued, have been discriminated against by additional, special taxes, even though these chains also reduce living costs by economical operation and by their policy of cutting prices. It must be remembered, however, that as cooperatives return a portion of their profits to purchasers or policyholders, such returns should be regarded as price rebates or refunds in direct ratio to purchases made or as member dividends in proportion to the size of policy owned. These returns are different in nature and in distribution from the dividends paid out of profits by ordinary corporations operated for gain to their stockholders in proportion to the amount of capital stock in the company owned by them. The net profits of cooperatives, after these returns to patronizing members, must be distinguished for taxation purposes from their gross profits before such refunds. Much legislation, makes this distinction.

Consumer cooperatives, *i.e.*, purchaser-owned cooperative stores, pay real-estate taxes, license fees, sales taxes, undistributed-surplus taxes, and most other forms of taxes imposed on ordinary commercial firms. Where net profits after premium returns on purchases made do result, profits taxes are paid. But income taxes are not paid on gross profits before rebates, for these are analogous to the price cuts of chain stores in that they are not retained by the merchandising organization; the general principle is the same despite the differences in method and timing. Retailer-owned warehouses, which are merely cooperative purchasing agents and distributing centers, do not seek or secure taxable income. They merely keep down costs of goods to their member retailers, who must pay taxes on the net profits made from subsequent sales.

Farm and producer cooperatives, however, have been exempt by law from Federal income taxes, including the undistributed-surplus tax. But the earnings of these cooperatives are distributed to their members on the basis of their trading operations. Hence, such so-called "profits" may be regarded as overcharges or excess earnings on these trading operations of their members. They are as transitory as they are illusory, for they are returned proportionately to those members to whom they belong as legitimate but belated reductions in the costs of commodities bought or services received.

If the members of purchasing cooperatives are ordinary business firms, which utilize the economies of collective buying, they pay income taxes. As their taxable incomes are increased by virtue of the lowered costs of the goods bought through their cooperative agency, the net profits ultimately received by the membership are finally and fully taxed, not at their source but at their destination on arrival. This attitude is sound and similar to that put forth earlier in this text relative to double taxation of the same base. But the favorable tax policy followed with some types of cooperatives is not consistent with current governmental practice in the double taxation of the income of ordinary business corporations. Not only are corporate profits taxed when they are made, whether distributed to stockholders or added to surplus, but also the dividends to individual stockholders are likewise taxed when subsequently received by them.

Guide Questions on Text

1. *a.* What are the essential features of a true cooperative?
   b. Compare a cooperative with an ordinary business corporation.
2. Compare cooperation with profit sharing. Indicate chief differences and similarities.
3. *a.* How does the cooperative movement differ from socialism?
   b. Wherein is it similar?
4. *a.* Outline different types of cooperation.
   b. Indicate differences and similarities.

5. Explain the origin and plan of the Rochdale cooperative store.

6. Why do you think that consumers' cooperation has met with less success in the United States than abroad?

7. *a*. What do you understand by producers' cooperation?
   b. Compare it with consumers' cooperation.

8. Has producers' cooperation been successful? Why or why not?

9. Explain and illustrate different types of agricultural cooperation.

10. Explain and illustrate different types of cooperative banking and loan organizations.

11. *a*. Show the significance of distributors' cooperation in the marketing of goods.
    b. Is it truly cooperative? Why or why not?

12. *a*. Why are mutual insurance companies cooperative?
    b. Should they be regarded as part of the cooperative movement?

Topics for Investigation

1. Rochdale pioneers in consumers' cooperation.
2. Producers' cooperation in France.
3. Cooperatives in Scandinavia.
4. Cooperatives in the United States for the marketing of fresh fruit, berries, and vegetables, particularly citrus crops.
5. Grain and cotton marketing cooperatives in the United States.
6. Cooperation among independent drug and grocery stores.
7. Mutual and stock companies in insurance.
8. Labor organizations and cooperative banking.
9. Savings and loan associations for home ownership.
10. Credit unions at home and abroad.
11. Attempts of cooperatives to restrict production and to stabilize prices.
12. Tax exemption or preference for cooperatives.

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CHAPTER XXXVI

ALTERNATIVE ECONOMIC SYSTEMS: SOCIALISM, COMMUNISM, AND FASCISM

36–1. Social Utopias. One of the earliest and most famous of all utopian schemes was Plato's "Republic," in which he pictured an ideal city-state. It was communistic, cooperative, and based on an inherent division of labor. Toward the close of the Middle Ages, William Langland wrote "Vision of Piers Plowman," an idealization of the England of his day in which many existing wrongs were righted. One of the greatest of all utopias, and the one which has given its name to similar proposals, was the "Utopia" of Sir Thomas More. It appeared about 1516 and sharply criticized many evils of Tudor England. In More's "Utopia" there were no dynastic wars, no leisure class, and no unemployment. The city beautiful contained public schools, free hospitals, and reformatories for criminals. A century later Francis Bacon published the "New Atlantis," of which his temple of science was a distinguishing feature. In it were the statues of scientists, inventors, and discoverers, rather than men of war. Among the more modern utopias are Edward Bellamy's "Looking Backward," William Morris's "News from Nowhere," and H. G. Wells's "New Worlds for Old."

Each age has dreamed its own utopia but has failed to reach it. Nevertheless, the ideals of one age have become the realities of a later period. A chronological survey of utopias will show both a raising of ideals and a progression toward former ideals. The advance in the ideals themselves is as significant as progress toward former ideals. Discouragement may be due to the fact that social ideals are advancing as rapidly as social development toward them. Hence progress can be made without its being realized or appreciated.

Social unrest, as reflected in the formulation of new ideals into fantastic and imaginative utopias, is a sign of progress, rather than an indication of the decadence of the times. Stagnation is the fate of those lands whose old men no longer have visions and whose young men are unable to dream. A progressive society is a critical society and one which is characterized by advancing ideals of social justice. Social unrest will always exist in a progressive society, but an unprogressive society will suffer from maladjustments of which it is not conscious. Self-satisfaction is as characteristic of a static society as of an unimaginative individual.

No society will ever reach its utopia; nor will any earthly utopia endure in a permanent and unchanging fashion. Utopias merely reflect the civilizations that give them birth. On the inside of his shield, the dreamer traces the maladjustments of his own day, which he then hammers into beautiful pictures of an ideal utopia, embossed on the obverse surface of the shield.

36–2. Economic Panaceas. An economic panacea is something that will quickly and painlessly cure all the ills of industrial society. Such a concept is as unscientific as the fountain of youth or the philosopher's stone that would turn base metals into pure gold. A panacea for all maladjustments of economic society is as imaginary as an economic utopia, but less inspiring. It is as dangerous as the quack doctor's nostrums and cure-alls, which divert sick individuals from competent physicians making careful diagnoses and prescribing specific treatments for particular ailments.

Socialism presents certain desirable ideals and the single tax gives us some useful suggestions, but neither will bring us to an economic millennium. To advocate any scheme of social reform as a general panacea for all economic evils, and as a perfect plan that will endure indefinitely in its original inspired form, is not only unscientific but also unfair to that particular program. Economic progress is made by the slow and steady elimination of economic maladjustments, rather than by the sudden regeneration of society through some revolutionary economic gospel.

36–3. Industrial Unrest and Social Progress. Social unrest is characteristic of a dynamic society. It arises from the consciousness of economic maladjustments and the desire to eliminate them. Social adjustment is a conscious and collective effort to raise the general level of group life toward desirable social objectives. It seeks to reduce the gap between current practices and the best of our acquired knowledge, between existing social institutions and accepted social ideals.

The process of adjustment may be either evolutionary or revolutionary, according to the rate of social change. It may be either peaceful or violent, according to methods through which the forces of social unrest express themselves. The progress of adjustment may be more or less democratic, according to the degree to which it is a popularly sanctioned mass movement. It may be rational or emotional, relatively permanent or ephemeral. Finally, social adjustment may be radical or conservative, according to the degree of social change. Etymologically, a radical is a root, or rather, one who seeks to get at the roots of things in order to make fundamental, not superficial, changes.

The development of popular education and democratic ideals has made for a greater sensitivity to economic maladjustments than ever before. Hence, social unrest exists now to an extent never before known. It is to be feared only when it remains submerged and inarticulate for decades, for

it will finally explode in a violent, emotional attempt at readjustment. The French and Russian revolutions illustrate this danger of long suppression, followed by sudden expression. Rational, peaceful adjustment is made by continuous, conscious improvements, not by frantic efforts of mob leaders to lift economic burdens from the backs of the oppressed masses.

Social unrest, in the past, has been expressed in both violent and peaceful methods. Both radical reconstruction and conservative reform have

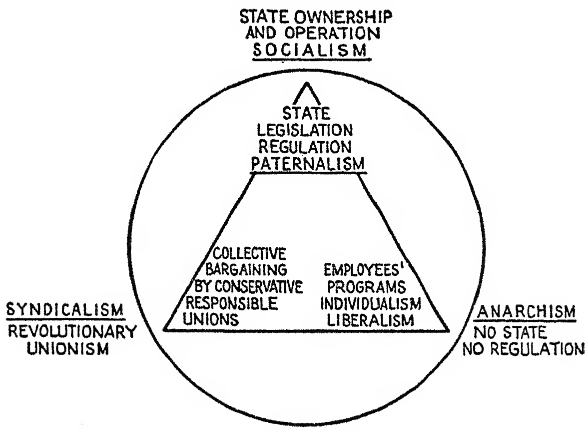

Chart 24. Industrial reform, reorganization, and revolution.

been attempted in the solution of our economic problems. Revolutionary anarchists and evolutionary socialists, nationalistic fascists and internationalistic communists have sought, each in his own way, to destroy capitalism and to create a new economic order. The ranks of labor, likewise, have been divided among conservatives on the right, radicals on the left, and liberals in the middle.

The more conservative forces of social adjustment, directed toward the amelioration of existing conditions, not toward fundamental economic reorganization, have expressed themselves through three main channels: (1) that of the state through legislation, (2) that of organized labor through collective bargaining, and (3) that of employers through various paternalistic programs. These three general methods of social reform have been outlined in previous chapters; we now proceed to a discussion of more fundamental or radical programs of economic, as well as political, reorganization of society.

Agencies of economic reform and those of economic reorganization are illustrated and separated in Chart 24. Chart 25 attempts to picture immediate choices and ultimate goals, as envisioned by spokesmen of the various socioeconomic doctrines and movements discussed in the present and final chapters.

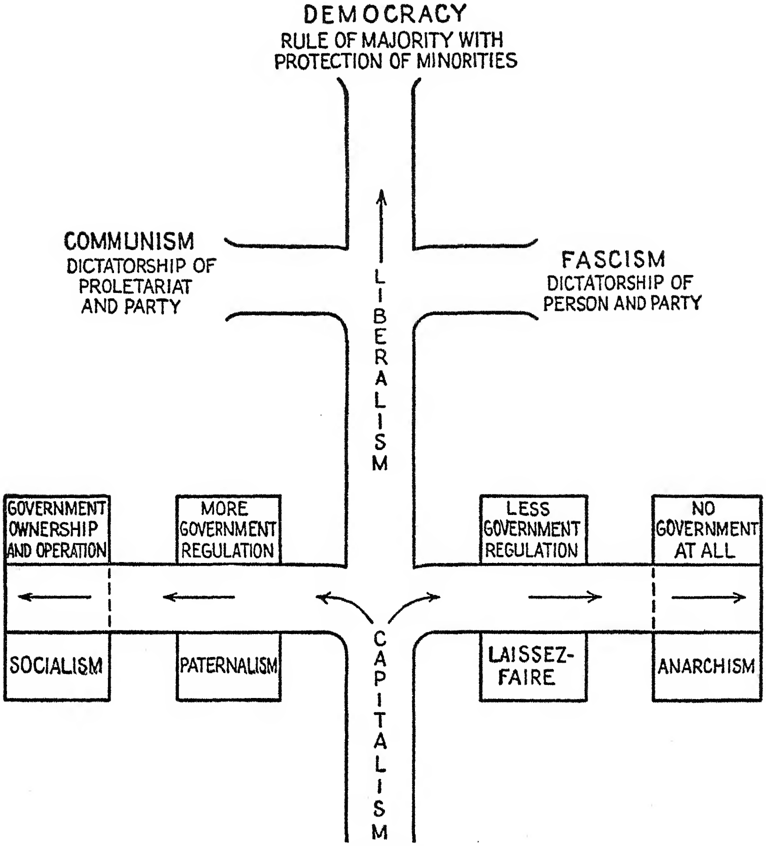

CHART 25. Parting of the ways.

36–4. Nature of Socialism. There are so many different types of socialism that it is difficult to define the movement with exactness. Only a broad definition is possible. The common essential in all schools of socialism, however, is the substitution of collective ownership and control of industry for private enterprise and the present capitalistic system. The profits motive as a stimulus to economic activity is to be replaced by the social-service motive. A democratic organization of the workers is to succeed industrial absolutism as it is developing under monopoly capitalism.

Socialism involves some fundamental changes in the institution of private property. Although permitting property rights in a certain amount of consumption goods, socialism attacks private-property rights in land and capital. Socialism seeks to eliminate private-property incomes from such sources as inheritance, rent, interest, and profits. Aside from various types of social insurance, wages would be the only form of income accruing to individuals, and all private incomes would be viewed as earned incomes.

Socialists differ among themselves on the issue of either equality or inequality of wages. They generally regard the salaries of brain workers, as well as the wages of manual laborers, as earned incomes.

Communists object to the institution of private property in general. They propose equality of income or distribution according to needs.

The cooperative movement would eliminate the individual enterpriser, and the single-tax movement the landlord; but socialism would go still further by eliminating also the capitalist.

State socialism is entirely different from anarchism. Anarchism seeks the reduction of governmental functions and the elimination of the political state, although this may be done by peaceful evolution, as well as by violent revolution. State socialism, on the other hand, seeks an increase of governmental functions, for it proposes that the state, as the representative of the workers in society, own and operate all basic industries. In short, the two movements are at opposite poles, for anarchists minimize political action, whereas socialists magnify it. Anarchism is the logical or illogical extension of rugged individualism or *laissez faire*. The state is not merely weakened; it is eliminated.

There are many programs of social reform that are socialistic but that are not socialism, because they do not involve the collective ownership and operation of industry. This is true, for example, of social insurance. The defeat of such measures is sometimes accomplished by the use of invective instead of intelligence. The specter of socialism often is paraded through the legislative halls with deadly effect.

36–5. Socialists' Indictment of Capitalism. Socialists usually begin their arguments with a criticism of the present economic system, rather than with a statement of the proposals of socialism. In a mind in which a burning consciousness of the evils of modern capitalism has been aroused, the promises of socialism stand out in bright relief. Remedial measures and other alternatives are slighted, and socialism in general or a certain type of socialism in particular is stressed as the one way of economic salvation.

a. Economic Wastes of Competition. One indictment of capitalism made by socialists is that the competitive capitalistic system is wasteful. There is an unnecessary duplication of material equipment and human effort. Thus the railroads developed as competitive enterprises under private enterprise. Because of competitive waste it has been proposed to create integrated railway systems in order to bring order out of chaos. Would it not have been better for the state or some other central agency to have directed the railroad development of the country from the outset? The present tendency under capitalism seems to be toward large-scale management and monopoly in many branches of industry, in order to avoid the wastefulness of competition. Some of the socially undesirable conse-

quences of private monopolies have been considered in an earlier chapter. Socialists maintain that these cannot be eliminated so long as private ownership of the basic means of production continues.

b. Economic Inequality. Another criticism of the present economic system arises from the persistence of glaring inequality in the ownership of wealth. We have seen how unequally the national income is distributed among the people of the United States. The nation possesses several hundred millionaires and several million paupers. Conspicuous consumption exists, on the one hand, and dire poverty, on the other. Socialists point out that, if all incomes were earned and if property incomes were eliminated, such economic inequality would be reduced.

c. Social Inadequacy of Profits Motive. The socialist also criticizes the profits motive, which serves as the stimulus to production under our present system. Market demand, rather than social welfare, is the indicator that production now follows. Inequalities in income make possible the production of luxuries for some before producing necessities for all.

Moreover, the quality of economic goods also suffers. It is at times profitable to produce shoddy cloth, to adulterate food, and to make things that are injurious to their users so long as they have a ready market. "Illth," rather than wealth, is the result.

Methods of production are as important as aims and results of production. Goods are now made in ugly factories that belch out clouds of smoke into the air we breathe, and that pour streams of refuse into the water used by towns farther down the river. Public health and aesthetic values are threatened by this spirit of gain. As shown previously, the conservation of natural resources is often impeded in a pecuniary society dominated by the profits motive.

The profits motive has developed our acquisitive traits and inhibited our cooperative efforts. The esteem of one's fellows, or social recognition, is desired by every member of society. The valor of the soldier and the research of the scientist are rewarded by the medal of merit and the laurel wreath, rather than by monetary compensation. For certain groups at all times, and for all groups at critical times, the social-service spirit transcends the profits motive. Such an incentive could be extended to normal industrial life, the socialists maintain, were it not that the profits motive has dominated our economic thinking and has expressed success in terms of the dollar mark. Social recognition, rather than the accumulation of fortunes, might have proved an adequate reward for those great captains of industry who have led the army of economic progress.

d. Capitalistic Exploitation of Human Resources. Finally, socialists indict the present capitalistic system as productive of human, as well as of economic, wastes. Not only does the profits motive lower the social plane of competition and degrade human behavior, but it is responsible also for

certain economic maladjustments, many of which have been discussed in earlier chapters. Child labor, unemployment, dangerous trades, and occupational diseases are laid by socialists at the door of modern capitalism. In spite of the fact that labor is the chief source of all wealth, the wages of many workers are inadequate to maintain decent standards of living. Because the instruments of production are owned by a propertied class, labor is exploited and does not receive the full value of its product. Much of this, it has been argued, would be reduced or eliminated by socialism.

36–6. Proposals of Socialism. *a. Collective Ownership and Operation of Industry.* The definition of socialism gives its fundamental proposal, that of collective ownership and operation of the instruments of production. Some socialists would apply collective ownership to all instruments of production (other than labor itself) and would permit individual ownership only of the worker's own home, clothing, and personal effects. More conservative socialists, however, would apply collective ownership only to basic industries. Between these two extremes are many compromise positions.

Most socialists would permit farmers the possession of some land for personal use; but cooperatively organized, collectivized agriculture would be the recognized basic form of farming organization. One farmer might not rent an excess amount of his land to another farmer, nor might he hire a laborer to till his land for him, for that would be exploitation by ownership without service. Individual tradesmen might be permitted in certain businesses that are by nature small-scale, but all large stores and manufacturing plants would be collective enterprises.

The change from individual to collective ownership of industry involves a process of confiscation to which many people object. The socialist replies that landlords and capitalists have already confiscated for themselves the free gifts of nature and the products of the labor of all workers. Socialism, therefore, is not viewed as confiscation, but as recovery. Moreover, the old argument of confiscation opposes all social reform. The abolition of human slavery involved the confiscation of the property of the widow who owned but a single slave. In order to avoid the charge of confiscation, a socialistic state might purchase private industries from their present owners by exchanging corporate securities for the government bonds of the new socialistic state. Subsequent inheritance taxes would limit the individual benefits from them to the present generation of owners. In this manner, collective ownership of industry might be established without outright or immediate confiscation.

b. Elimination of Property Income. Socialism proposes the elimination of most forms of individual income except wages and social insurance. Although earned income is the only type that socialists recognize, this includes the rewards of brain as well as those of brawn. Moreover, it does

not follow that all incomes would be equal under socialism, as is often asserted.

Communism, as distinguished from socialism, is predicated on the doctrine, "From each according to his ability and to each according to his needs." A communistic system of distribution is one of even greater equality of individual incomes than under socialism, but one that recognizes differences due to variations in the size of the family and also due to varying requirements for the fullest self-realization. The ideal of most socialists, however, is that of acquisition according to productivity along socially desirable lines. Such a system of distribution has been termed a functional economy, as compared with the inequalities of an acquisitive society.

c. Wage Determination. Most socialists recognize the necessity for a wage differential in proportion to some measure of economic productivity. If all workers received the same wage, irrespective of their economic productivity, there would be a dangerous tendency toward idleness or soldiering on the job. To apportion income according to the size of the family would be to accentuate the Malthusian tendency and to reward biologic productivity, rather than economic productivity.

The exact method of determining wages under socialism is a matter of considerable controversy. There would probably be a minimum wage in order to prevent any individual from living below a decent standard of living. Above this line, wages would vary according to the objective productivity of the workers. This productivity would be measured roughly as under capitalism, in terms of value product attributable to individual units of labor. Consumers would be free to express their preferences for goods in markets, and thus might give direction to the production of consumers' goods by their individual preferences. But there would be no enormous salaries or property incomes under socialism. In a socialized economy, production would proceed according to a plan that aims at realizing previously determined social objectives. Production would not be guided, as under capitalism, by the "anarchy" of the market, although a controlled price system would exist.

d. Money and Price System. Either commodity money or inconvertible paper might be used under socialism, although there would be no private banks or bankers. Socialism does not necessarily involve an abandonment of the gold standard or of ordinary credit currency. On the other hand, wages might be paid in labor checks, functioning as money, which, in turn, could be used for the purchase of goods from government stores at politically fixed prices. The money wages received by labor would represent the liquid income, which the wage earner could employ to express his individual preferences for goods. Such expression of preferences, in turn, could be used by the planning agencies, if it conformed with their predetermined goals, to guide production and fix prices, very much as under a capitalistic system. Through price control, the planning bodies could guide

consumption into socially desirable channels. Thus while there would be consumer preference recognized under socialism, there would not be consumer sovereignty, as under capitalism.

e. Industrial Democracy. Socialism proposes to substitute an industrial democracy for an industrial absolutism. Control by the workers through some form of industrial representation is regarded as essential. This factor in socialism was overlooked by many early state socialists, who proposed to substitute governmental ownership and operation for individual initiative in industry, but who failed to provide a method for the democratization of industry. State socialism with its centralized governmental bureaus failed to give the workers a voice in the control of industry. Hence guild socialism developed its ideal of the self-governing workshop.

f. Miscellaneous Proposals. There are other projects of socialists, which, although not a part of socialism in the strict sense of the word, are generally associated with it. Thus, socialists propose certain educational reforms. Children would be prevented from leaving school at an early age to go to work. Educational opportunity would be extended in all directions. Governments, rather than benevolent individuals, would be the builders of museums and art galleries. The state would become the patron of the arts and sciences. Community centers, parks, and playgrounds, as well as supervised theaters, would be provided for the recreation of all citizens of the socialist state.

Health and safety in industry, as well as improved housing and better living conditions, would be promoted. Municipal tenements would take the place of slums. Public hospitals would be open to all; and many physicians would be governmental officers paid by salaries, rather than fees. Social insurance is not socialism, but the latter generally includes the former. A socialistic state would provide not only workmen's compensation for industrial accidents, but also sickness insurance, maternity benefits, unemployment compensation, and old-age pensions.

36–7. Tenets of Karl Marx. The "Communist Manifesto," by Marx and Engels, published in 1848, the year of the revolution in central Europe, was the political platform of Marxian socialism. It contained various proposals of the new socialist party for that time.

"Das Kapital," a later work of Marx, contains an elaborate exposition of the revolutionary economic theories leading to Marxian socialism. It has been regarded as "the Bible of Socialism." "Das Kapital" is to socialists what Henry George's "Progress and Poverty" is to single taxers. This monumental work is basic to an understanding of all theories of socialism, whether of Marxian or of dissenting schools. It is fundamental likewise to communism and syndicalism.

Marxism, known also as "scientific socialism," is so essential to the entire philosophy of socialism that some of its leading principles must be outlined in any discussion of socialistic theory. These include the materialistic

interpretation of history, the doctrines of the concentration of capitalistic control and the exploitation of the proletariat, the theories of labor value and surplus value, the overproduction theory of industrial crises, and the doctrine of class struggle.

Marx's materialistic interpretation of history, in brief, is that modes of production determine the seat of political power and the type of culture. In other words, political life, social institutions, and even religious and moral ideas are vitally affected by the economic institutions of production and exchange existing in any given period of history.

The invention of power machinery and the introduction of the factory system at the time of the Industrial Revolution resulted in the substitution of large-scale production for small-scale production. The craftsman and the small independent producer gradually disappeared. Indeed, according to Marxian doctrine, the middle class will ultimately cease to exist. Again, there is a growing concentration in the control of industry, illustrated by the modern trust and holding company. While the capitalist is increasing in power and wealth, the workers are said to be suffering from ever-increasing poverty and misery.

Closely connected with his theory of surplus value is Marx's doctrine of the exploitation of the proletariat, *i.e.*, workers who have been dispossessed of their instruments of production by the bourgeoisie, namely, the capitalists or owners of the instruments of production. Starting with the then current classical theory of Ricardo, Marx contended that the value of any commodity depends on the quantity of socially necessary labor contained in it. The productivity of capital unaided by labor was denied, and labor was regarded as the primary or ultimate source of all wealth. Capital was regarded by Marx as stored-up labor. Inasmuch as interest, rent, and other forms of property income are recognized under capitalism, the worker in a capitalistic society does not receive all the wealth that he produces. A surplus value, or the difference between the wages of the worker and the value of his product, is appropriated by the capitalist. Hence the laborer is exploited.

Another principle of Marxian socialism is that of overproduction as the cause of industrial crises. Because of the existing inequality in the distribution of wealth and the continued appropriation of surplus value by the capitalists, the working classes in society cannot buy back the products they produce with the wages they receive. On the other hand, the wealthy property-owning groups have an income in excess of their needs and are forced to invest a large share of it in productive enterprises. The result is a further increase in production until more consumption goods are in existence than can be disposed of at profitable prices. This leads to an economic depression, or a halting of the processes of industry until consumption again catches up with production. The socialists point to our recur-

ring economic crises as proof of this doctrine of "overproduction." They contend that crises are inevitable under modern capitalism, and that they are becoming steadily worse. As they will finally become intolerable, capitalism, says Marx, carries within itself the seeds of its own destruction.

A final principle of Marxian socialism is that of the class struggle along economic lines. History records the old and continuous story of the inevitable conflict between masters and slaves and between lords and serfs. The Industrial Revolution created an irremovable and ever-widening gulf between the bourgeoisie and the proletariat, *i.e.*, between capitalists and workers. Scientific socialism does not preach revolution so much as it regards it as unavoidable. As the middle class disappears with increasing concentration of ownership on the one hand, and a growing propertyless class on the other, the conflict of interests between the two extremes in society will become more and more intense. The dispossessed workers will finally rise in their might. By sheer power of numbers, they will take possession of the instruments of production and operate them collectively. The "wage slavery" of modern industrialism will then be eliminated by the dictatorship of the proletariat.

Such were the basic assumptions and fundamental conclusions of "Das Kapital." This mere outline of the underlying principles of Marxism is obviously too brief to state them thoroughly and with sufficient qualifications.

36–8. Criticism of Marxism. One of the weakest links in the Marxian doctrine is the labor theory of value, which has been abandoned by neoclassicists. Even if it be admitted that labor is the ultimate source of all wealth and that capital itself is stored-up labor, the fact remains that roundabout production, or labor aided by capital, is more productive than labor unaided or directly applied. The socialist himself will admit the superior productivity of capitalistic labor, but he demands the collective ownership and operation of capital on the grounds that labor, in the first instance, has produced all capital. Labor as a measure of value is even more difficult to defend than labor as the source of all value. Marx assumes homogeneous units of labor, like the clock hours of an unskilled worker, the number of which would determine the value of a coat or a book. This abstraction is impractical as a measure of costs of production. The labor theory of value also minimizes the factor of demand, as influenced by the divergent desires of consumers. Of what value is the product of a given number of labor units if no one has any desire for it? Marx merely assumes that the good is socially desirable and does not provide for varying degrees of utility.

The Marxian concept of overproduction needs considerable refinement. Although there can be specific misdirected production or general oversupply in the sense of more goods than can be disposed of at cost prices,

general overproduction, as previously indicated in our discussion of unemployment, is impossible in the sense that more goods can be produced than can be consumed. If such were possible, "production" could no longer be properly defined as the creation of want satisfaction in economic goods. On the other hand, the socialist is probably correct in his contention that greater equality of income would have a stabilizing effect on industry by increasing the effective demands of workers. There may be underconsumption, overinvestment, and misdirected production, even though general overproduction is impossible.

Although a growing concentration in industry may be taking place, it does not follow that the middle class is disappearing or that society can be divided arbitrarily into two hostile groups of exploiting bourgeoisie and exploited proletariat. Today, the stock of many great corporations is widely held by thousands of small stockholders. Again, the laboring class is materially better off now than at the time when Karl Marx wrote "Das Kapital." In spite of the persistent inadequacy of the wages of a large portion of our laboring population to keep up with rising standards of living, the long-run tendency of real wages and actual planes of living has been upward in capitalistic countries.

36–9. Utopian and Christian Socialism. Although socialists are united in their indictment of capitalism and in their proposal to substitute collective ownership and operation of the instruments of production for individual enterprise and private-property rights, they differ widely among themselves as to other proposals and as to methods by which this main objective of socialism is to be accomplished. Hence it will be necessary to outline different schools of socialism, most of which stem from Marx, although some of them precede and differ from Marxism.

The term "utopian socialism" is generally restricted to a small group of writers who lived in the closing years of the eighteenth century and the opening years of the nineteenth century. These include Saint-Simon, Fourier, and Proudhon in France, and Robert Owen in England. Inspired by the philosophers of the French Revolution, they dreamed of an ideal society in which voluntary cooperation would replace competition and coercion. This movement expressed itself in numerous communistic societies, such as New Harmony in Indiana and Brook Farm in New England.

As a reaction against the fantastic and atheistic character of some proposals of early utopian socialists, Christian socialism emerged. It developed in England under the leadership of F. D. Maurice, J. M. Ludlow, and Charles Kingsley. It stressed the immoral, rather than the uneconomic, character of our present industrial system. It preached the gospel of the brotherhood of man and the dignity of labor. The first great socialist was He who enunciated the fundamental commandment that man should love his neighbor as himself. Christian socialism spent itself in human-

itarian legislation and in the development of higher ideals in industry. It sought to carry the Golden Rule into economic society.

36–10. State Socialism and Fabian Socialism. State socialism has been regarded as the practical application of scientific or Marxian socialism. It may be said to date from the Congress of Eisenach in 1872. State socialism has sometimes been termed "socialism of the chair" because of the advocacy of its doctrines by certain German professors of economics. It magnifies the importance of the state as the fundamental social institution and proposes to extend governmental functions to industry. State socialism favors the public ownership and operation of basic industries, and the allocation of productive resources among their alternative uses according to plan.

Whereas scientific or Marxian socialism is revolutionary, Fabian socialism is evolutionary. The Fabian Society of London was organized in 1884 by a small group of English intellectuals. The name was derived from the Roman general, Fabius Cunctator, or the delayer. The abandonment of his waiting policy in the campaign against Hannibal, the Carthaginian general, brought disaster to the Roman republic. In a similar manner, popular education is regarded by Fabians as a necessary preparation for socialism. It would be unfortunate for it to come to pass before the great mass of citizens were ready for it. Hence a keen critic of modern industrial society has characterized the Fabian socialists as those who pray, "Give us socialism, O Lord, but not in our time."

Fabian socialism teaches that socialism is to come by the gradual process of peaceful change through education, rather than by the sudden method of violent revolution. It points out that monopolies are becoming more and more prevalent and that governmental regulation is constantly widening. It is but a step from regulation to socialization, and Fabian socialists propose the gradual nationalization of all important industries. Thus socialism will come almost unconsciously.

Fabian socialists include such brilliant writers as H. G. Wells, George Bernard Shaw, and Sidney and Beatrice Webb.

36–11. Guild Socialism. Guild socialism was a more recent but more ephemeral cult of socialism. It may be regarded as a hybird of socialistic theory and trade-union machinery. It developed in England as a reaction against the centralized bureaucracy of state socialism. G. D. H. Cole was one of its chief expositors and advocates.

Guild socialists claimed that the factory system had robbed the worker of his independence, and that the machine process had stifled the joy of workmanship. Like John Ruskin and William Morris, they idealized the craftsmanship of the medieval guilds and revolted against the modern regimentation of the worker and the standardization of his product.

The guild socialist's plea was for self-government in industry, which, it was felt, could not be accomplished under state socialism, because the latter

would necessitate the autocratic control of industry by cabinet ministers or state departments of industry. Guild socialism would use the administrative machinery of modern trade unions, but in some mysterious way it would breathe into them the spirit of the medieval craftsman. It was not a revolt against the machine process itself, however, such as Ruskin and Morris voiced in their writings, or as Gandhi has preached in India.

Under guild socialism, foremen would be elected by the workers, and there would be shop committees and works councils. A national guild congress would represent the workers of the various industries in some such way as the American Federation of Labor represents the different groups of workers in the United States. Professional and clerical groups, however, would also be represented. Thus there would be guilds of physicians and teachers, as well as guilds of carpenters and miners.

Guild socialism proposed an industrial, as well as a territorial, representation; it planned an economic, as well as a political, democracy. A dual concept of the state was involved. Some concepts of guild socialism found their way into Fascism and Nazism, but in perverted forms.

36–12. Syndicalism. Syndicalism is sometimes incorrectly classified as a radical type of socialism, because most syndicalists accept the socialistic indictment of capitalism and the leading theories of Karl Marx. But they stress economic, rather than political, action. Syndicalism has also come to be regarded as a revolutionary type of labor organization, because it favors industrial unions instead of trade unions, and direct action or violence, instead of peaceful collective bargaining. Syndicalism seeks the overthrow of capitalism, rather than merely higher wages and improved working conditions.

Syndicalism proposes one big union of all workers and the elimination of the present political state. It ignores the legislative activities of numerous socialistic groups that look toward a gradual nationalization of industry. Syndicalists advocate the general strike and condone the weapon of sabotage. They accept the Marxian principle of class struggle and eagerly await the economic revolution of all workers of the world, which is to be sudden and violent.

The new industrial state is to function through local bodies of workers and their national representatives. Syndicalism differs from guild socialism in that it is revolutionary, not evolutionary. Moreover, it does not propose industrial representation in addition to political representation, but in lieu of it. Control is to be in the hands of the workers who are numerically the strongest group under a dictatorship of the proletariat, achieved by violent revolution. There is much in common between syndicalists and communists, both of whom claim to be Marxists.

36–13. Meaning of Sovietism and Bolshevism. Sovietism, in the strict sense of the word, refers to a form of industrial or occupational represen-

tation, in contrast to political or territorial representation. Soviets are workers' councils, elected by the workers in specific occupations to represent them in the local and national assemblies. Thus in the Soviet Union there are both local soviets and provincial soviets.

Bolshevism merely means majority. Bolsheviki was the term applied to those who, at the Socialist Party Congress in London in 1903, represented the majority, favoring direct action on the part of a militant revolutionary group. They held that the seizure of power by the proletariat need not await the development of a highly organized industrial society, but might be effected by a small, well-disciplined minority, using its power to combat the bourgeoisie and to accelerate the achievement of socialism. In the Russian revolution of 1917 the Bolshevists were not the majority, but a very militant minority that succeeded in gaining control of the Russian government. It is often the case in revolutions that small groups, well organized and disciplined, succeed in dominating the situation. The former "Bolshevik party" in Russia changed its name to the "Communist party" in 1920, and has been designated accordingly ever since.

36-14. Achievements of Socialism. A sketch of the development of socialism is difficult because of the existence of so many different types and movements. The First World War and the Russian revolution divided socialists still further. A proper appraisal of their strength must include such an allied movement as that of the British Labor party.

Indirect accomplishments of socialism are perhaps of more importance than its direct achievements. Thus socialism has often revealed itself as the voice of social unrest speaking against existing evils and in favor of laws such as social insurance, progressive income and inheritance taxes, and the public ownership of utilities. An appraisal of the strength of socialism must include not only its allied movements, but also its indirect influences.

At the present time, however, socialism is not merely the economic philosophy of a small group of visionary idealists, but the practical political conviction of a large number of statesmen and voters. There are one or more socialist parties in every important nation. Socialists of some type are now in control of the government in many parts of the world.

36-15. International Workingmen's Associations. Socialism has been an international, rather than a national, movement. Hence it calls upon the workers of all nations to stop capitalistic warfare and to unite in a new war against capitalism itself. The first such international appeal was that of the "Communist Manifesto" issued in 1848.

An International Workingmen's Association was formed in 1864, which developed into what was known as the First International. It endured until disrupted by the crisis of the Franco-Prussian War and by a schism between Marxian socialists and communist anarchists under the leadership of the Russian radical, Bakunin.

The Second International was inaugurated in Paris in 1889 as a protest against militarism. The triumph of nationalism during the First World War meant the temporary breakdown of this Second International, which was not revived until after the cessation of hostilities.

The Third, or Communist, International was organized in Moscow in 1919. It is a reaction against political and evolutionary socialism. A product of Russian Bolshevism, it sought to spread to other lands the system of soviets or workers' councils. Conservative socialists refused to affiliate themselves with the Third International, or Comintern, but have clung to the Second International. The Comintern was formally dissolved in 1943, in the midst of the Second World War. But there is a strong likelihood that it will be revived in the postwar era. The "common front" of socialists and communists against Fascism and Nazism was merely a war measure. It was succeeded by the "cold war" of propaganda and political pressure between eastern totalitarian states and western democracies.

36–16. British Labor Party. The British Labor party is a complex of trade-union machinery and socialistic principles. Its policy is opportunistic, but constitutional. It savors more of Fabian and guild socialism than of Marxian or state socialism. The program of the British Labor party includes the nationalization of the Bank of England, the railroads, mines, and other large industries, as well as the socialization of extensive private holdings of land. Strict governmental regulation is proposed for what industries are left to individual enterprise. The reduction of economic inequality is sought through progressive income and inheritance taxes. Strong belief in social insurance is maintained and opposition is expressed to any reduction in its scope and benefits.

The British Labor party has long been a powerful factor in national politics. During the last generation, it grew more rapidly and more consistently than any other party in Great Britain. By 1924, the British Labor party had become the strongest single party. Consequently, it was called upon to form a coalition ministry. Ramsay MacDonald, as leader of the Labor party, became Prime Minister of England, which office he held almost continuously for the following decade.

In the national election of July, 1945, the British Labor party again received the mandate of the people to form the government, by winning an actual majority of the seats in the House of Commons for the first time in its history of nearly forty years. It won the election on a platform proposing the extension of nationalization in Great Britain. The 5,000-word declaration of its policies in the party platform reaffirmed their endorsement of such items as the following: (1) nationalization of the Bank of England; (2) public ownership of fuel and power industries; (3) public ownership of inland transportation by land, water, and air; (4) public ownership of iron and steel industries; (5) public supervision of monopolies

and cartels; (6) state aid to export trade; (7) planned investment in essential industries under a National Investment Board.

Within a year after taking control of the government in 1945, the British Labor party had nationalized the Bank of England, British air transport, and the coal mines. Nationalization was accomplished on the basis of fair compensation to private owners and not by confiscation. In general, it proceeded according to the principles of gradualness acceptable to Fabian socialists, and was carried out by orderly, democratic means, rather than by direct action and confiscation, as was done in the Russian revolution of 1917. Not only tactics and procedure, but also immediate objectives of the British Labor party differed significantly from those of the Communist party in Soviet Russia. They thus distinguished sharply the movement toward socialism in Great Britain from the development of state socialism in Soviet Russia, which will be described in the concluding chapter.

36–17. Capitalism and Socialism. Students of economic problems may agree with the socialists' indictment of capitalism without accepting socialism as the best way out of the dilemma. Moreover, they may accept the ideals of socialism without believing that socialism will successfully bring them to pass. One must admit the economic and human wastes of the capitalistic system. One may admire the attempt of democratic socialists to substitute public service for the profits motive. It is necessary, however, to raise constantly the practical question as to the effectiveness of socialism in practice. Neither the success nor the failure of socialistic developments in Great Britain, as claimed by the adherents to, or opponents of, the British Labor party, would serve as proof of their applicability in other countries, particularly in the capitalistic United States.

Although socialism may gradually improve human behavior, we live in an acquisitive society. Self-interest is an instinctive force and the profits motive a powerful incentive. It is possible and desirable, however, that our inherent or acquired desire to win social recognition can be expressed in some other way than in the mere accumulation of wealth. But it is doubtful that individuals will exert themselves so strenuously for the good of society as for their own individual welfare and that of their immediate group, as socialists would have us believe.

36–18. Fascism and Nazism. As a result of the overthrow of the fascist regime under Benito Mussolini in Italy and of the Nazi [1] control by Adolf Hitler in Germany, fascist governments were limited to Spain and other minor states. Fascism again became a matter of history, at least for the time being, and a world problem of little contemporary significance. But ideologies and doctrines are not destroyed by war. They live on and may even win new advocates and disciples in the suffering and chaos growing out of total war. Although the enemies of the fascist powers were

[1] Abbreviation of National Socialism.

victorious in a military sense, they have by no means uprooted fascist doctrines. People in defeated fascist countries may indeed be deriving a certain degree of vicarious satisfaction from seeing their fascist ideologies perpetuated among their conquerors.

It is, therefore, necessary, in an analysis of current economic problems, also to examine the doctrines of Fascism, for they contain many challenging doctrinaire proposals for dealing with both political and economic issues facing various countries today.

It is somewhat difficult to formulate a precise definition of Fascism, since in practice it has taken on different forms and various meanings in different countries. To some people, any movement that is repugnant to them is called "fascist." The old Roman word *fasces* meant bundles of rods surrounding an ax with a projecting blade. For fascists this symbol expressed rigid discipline toward national unity, impressed upon divergent elements in the political state. (Incidentally, it is the symbol of national unity contained on the old American 10-cent piece.)

36–19. Fascism and Marxism. Ideologically, Fascism differs basically from Marxian socialism and communism. Fascists denounce the hampering effect of industrial and class antagonisms on production; they hold that class struggle in the Marxian sense militates against that unity of purpose so essential to the effective functioning of modern industrial society, based on minute division of labor. Fascists also maintain that the Marxian division of society into hostile classes, the capitalist and the proletariat, is not in accordance with present-day reality, with its many divergent economic groups and categories.

Fascism would seek to unite all divergent interests under a powerful national ideal. This necessitates subordinating private control over economic processes to public or political control, *i.e.*, the control of an all-powerful state. Individual and class interests are subordinated to the ideal of group solidarity and group cooperation. "Commonweal over individual well-being" and "The individual is nothing, the people (*Volk*) are everything," were popular Nazi slogans that epitomized fascist ideology. Under Nazism in Germany, perhaps even more so than in fascist Italy, the ideal of state power, as well as that of group solidarity, was developed. It found extreme expression in doctrines of racial purity, Aryan superiority, and anti-Semitism.

Fascism requires state supervision of all activities relating to national well-being. The fascist state, moreover, is not interpreted in the Marxian sense as the product of irreconcilable class antagonisms, but is regarded as an organic, dynamic being. It has an existence apart from the people in the state, even as a business corporation has a legal existence separate from the stockholders. The expression "the corporate state" suggests this analogy between the concept of the fascist state and a corporate legal entity.

Whereas the philosophy of communism is based on the theory of the development of a classless society, with the eventual withering away of the political state, Fascism recognizes the continued existence of class differentiation and class stratification within the state. Through the exercise of state authority it seeks to coerce the stratified classes into a coherent and cooperative entity.

While Marxian communism is an international doctrine, Fascism is distinctly nationalistic. The fascist doctrine of national unity and strength finds expression in the advocacy of increased population, national self-sufficiency, and military power as the symbol of national prestige. It is also revealed in intensified patriotism and the development of a strong feeling of sovereign rights of nations, which may easily grow into an aggressive spirit of intolerant superiority.

36–20. Fascism and Capitalism. The fascist interpretation of the state implies the negation of the concept of democracy, in which the state is viewed as the servant of the people and as existing primarily to safeguard the rights of individuals. Political authority under Fascism centers in a single legally recognized political party, the aristocracy of the elite, with a dictator at its head.

The economic organization of fascist society is conditioned largely by the broad political objectives of the nation. "For the statesman or the citizen there can be no more than a technical separation of the field of economics from that of politics. Every aspect of life merges into and is conditioned by the rest." [1] Some students have related the development of fascist doctrines to monopolistic capitalism, controlling large segments of industry, and finally obtaining control of government itself with a view to promoting their own interests and to perpetuating their power.

The foregoing résumé of fascist doctrines suggests that in most modern capitalist countries, with their trend toward monopolies and big businesses and their social stratifications, there are fascist elements that would seize and use the authority of the state to achieve their power objectives by the exercise of force and threats of force, under the guise of national unity and harmony. Some would invoke state power to protect their property interests, avowedly against the threats of socialism and communism. Others, in the alleged interest of national unity, would seek to use the authority of the state to curb the increasing power of organized labor. Still others, seemingly, would strive to promote national purity by expounding doctrines of racial supremacy in one form or another. Behind all such proposals and doctrines for dealing with modern economic, social, and political problems lurks a certain amount of fascist ideology of superiority and force, even though this would no doubt be vehemently denied by their proponents.

[1] Finer, Herman, "Mussolini's Italy," p. 168, Henry Holt and Company, Inc., New York, 1935.

Fascism is a world-wide movement, with more or less powerful Fascist elements in almost every capitalist country; and practically all the careful students of the subject are agreed that there is grave danger that the United States may adopt some form of Fascist government eventually.[1]

If such an eventuality were to arise, it would spell the end of our democratic institutions and result in the substitution of the philosophy of superpower and force for the philosophy of individualism, on which our capitalistic social order has been established. Sinclair Lewis's novel "It Can't Happen Here" is an imaginary picture of what might happen in the United States in the not too distant future under a fascist government.

Guide Questions on Text

1. Explain and illustrate the nature of social utopias.
2. Account for the development of utopian writings.
3. "Social unrest is a characteristic of a dynamic society."
   a. Explain what is meant by "social unrest" and "dynamic society."
   b. Do you agree with the above quotation? Reasons.
4. How may social unrest express itself? Is it good or bad? Why?
5. What are the basic tenets of socialism?
6. Distinguish between state socialism and anarchism.
7. Evaluate critically the socialist's indictment of capitalism.
8. Summarize the basic proposals of socialism.
9. Criticize the socialist slogan "production for use and not for profit."
10. How would wages be determined under socialism?
11. What is the function of prices in a socialized economy?
12. Marxian socialism has been referred to as "scientific" socialism. Explain.
13. Summarize the basic doctrines of Marxian socialism.
14. Criticize the Marxian theory of surplus value and theory of overproduction.
15. Distinguish among the various schools of socialism.
16. Explain what is meant by sovietism, Bolshevism, and communism as applied tc Soviet Russia.
17. What is Fascism? Compare with Nazism.
18. "Ideologically, Fascism differs basically from Marxian socialism and communism." Explain and illustrate.
19. What evidence is there of fascist ideology in the United States?
20. What dangers to our traditional institutions are contained in fascist doctrines?

Topics for Investigation

1. Functions of prices in a socialized economy.
2. Methods of socialization by democratic means.
3. Socialist incentives to productive efficiency.
4. Similarities and differences between socialistic developments in Great Britain and the Soviet Union.
5. Determination of capital formation under socialism.
6. Progress of socialism in last century.
7. Socialism in Europe compared with the United States.

[1] Ise, John, "Economics," p. 664, Harper & Brothers, New York, 1946.

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CHAPTER XXXVII

ECONOMIC RIVALRY: THE SOVIET ECONOMY AND ITS INTERNATIONAL RELATIONS

37–1. Differences and Similarities. Before considering the problems arising out of economic relations between the Soviet planned economy and capitalistic economies, some understanding of the nature and functioning of the Soviet economic system is necessary. The present Soviet economy differs basically in its objectives, as well as in its organizational structure, from our peacetime capitalistic economy. Hence the methods of dealing with internal problems in the Soviet Union relating to the pricing process, money and credit controls, wages, employment, foreign trade, capital formation, and the allocation of productive resources in general, also differ from those normally prevailing in a capitalistic society. However, during the Second World War our governmentally directed economy showed many similarities with the working principles of the Soviet economic system: "Similarity of objectives results in a similarity of problems and ways of meeting them." [1] Wartime rationing of civilian goods, wage and price controls, priorities and allocation of strategic materials were all measures that had their prototypes in the Soviet economy.

But after the close of the Second World War, with the reconversion of our economy to a peacetime basis and the progressive relinquishing of wartime governmental controls, the essential differences between the Soviet economy and our capitalistic economy became increasingly apparent. They caused some critics to view the Soviet system as a menace to the institutions of capitalism, while others accepted them as a challenge. A better all-around understanding of the organization and operation of the Soviet system is essential, if we would allay apprehension and seek to develop mutually beneficial peacetime economic relations between Soviet Russia and the capitalistic world, in general, and between the United States and Russia, in particular.

Moreover, such an understanding would also suggest that the type of authoritarian or state socialism existing in the Soviet Union offers no acceptable solution for the many economic problems confronting our capitalistic economy today, which have been analyzed in the preceding chapters.

[1] LANGE, OSCAR, Working Principles of the Soviet Economy, in "U.S.S.R. and the War," p. 38, Russian Economic Institute, New York, 1943.

The Soviet economic system, popularly but erroneously called "communism," is so completely different from the basic institutions of capitalism that it makes very little, if any, appeal as an alternative, even though one may fully recognize the many difficulties facing the continued smooth functioning of our capitalistic system. The current economic problem is not one of evaluating the Soviet economy as an alternative to our capitalistic society, but rather one of understanding the Soviet system, with a view to developing harmonious peacetime relations between two rival systems. The rivalry need not be hostile, as some would have us believe, but can be peaceful. Basically it necessitates abiding by the "rules of the game" arrived at by mutual agreement between the Soviet government and that of the United States.

As we have seen in the preceding chapters, even in capitalistic countries, social control and public guidance in both domestic and international economic affairs are superseding the era of traditional economic liberalism and *laissez faire*. Particularly in the development of commercial relations between two different economic systems, governments, whether democratic or authoritarian, must create the structural foundation on which individual traders in capitalistic countries may establish commercial relations with a state trading monopoly, such as that of the Soviet Union. A primary requisite for the creation of such a framework is the mutual understanding of the essential characteristics of the two rival economic systems. While the present chapter is devoted to an analysis of the Soviet economic system and its international economic relations, it is assumed that the student is familiar with the basic principles governing the functioning of our present-day capitalistic system, and the role played by government in giving direction to the economic activities of our society.

37-2. Historical Development. Since the October Revolution, in 1917, the Soviet economy has undergone several significant changes, until today (1948) it has reached the stage of state socialism. In the strict Marxian sense, pure communism has not yet been realized in Soviet Russia—nor is there much indication that it will be achieved in the foreseeable future. According to Marxian doctrine, communism will be attained only after society has passed through the necessary evolutionary stages. Nikolai Lenin, interpreter of Marx and fearless leader of the Russian revolution, recognized four such stages in the transition from capitalism to ultimate communism, namely, (1) capitalism, (2) dictatorship of the proletariat, (3) socialism, (4) communism.

As a result of the October Revolution, in 1917, capitalism was overthrown in Russia, and according to communist spokesmen, the dictatorship of the proletariat was established. But this theoretical proletarian dictatorship in reality has become the dictatorship of the Communist (Bolshevik) party, regarding itself the vanguard of the proletariat. It has

been the only legally recognized political party in the Soviet Union since the October Revolution.

Article 126 of the Soviet constitution of 1936 defines the Communist party as "the vanguard of the working people in their struggle to strengthen and develop the socialist system and the leading core of all organizations of the working people, both public and state." While in 1941 the Soviet Union had an estimated population of 192.7 million, the Communist party had a membership of only about 2.5 million, or 1.3 per cent of the total population.

With the abolition of private ownership of land and the nationalization of basic industries, the foundation was laid for the creation of a new social and economic order in Soviet Russia. But before socialism could be achieved, the dictatorship of the proletariat, in the form of the Communist party dictatorship, sought to suppress and "liquidate" the remainder of the capitalist or bourgeois class. When the party in control felt that these objectives of the dictatorship had been achieved, it set about to reorganize the Soviet economy, with a view to developing socialism as the next necessary stage to ultimate communism.

This movement toward attaining the third stage in the transition from capitalism to communism had its inception with the First Five-year Plan, which began in 1928–1929 and reached a climax with the adoption of the Constitution of 1936. Prior to 1928 the Soviet Union had sought to restore that which had been destroyed as a result of the First World War and the civil war that followed. The New Economic Policy was adopted in 1921, reintroducing a certain amount of private trade for personal profit. This was viewed as a strategic retreat by Communist leaders in order to gain time to develop a comprehensive socioeconomic plan for the socialist reconstruction of the Soviet economy. But, as we shall see later, the government did not relinquish its monopoly of foreign trade, in spite of the many concessions it made to private enterprise under the New Economic Policy. During the period of so-called "war communism" from 1918 to 1921, when civil war raged in Soviet Russia, forceful requisitioning of supplies had been resorted to by the government, but this was subsequently replaced by a tax in kind on agricultural products. Peasants were permitted to sell any surplus products they might have in open markets.

Under the New Economic Policy the Soviet government also reintroduced a monetary unit, legally related to gold, in order to facilitate the development of commerce and trade. The period from 1921 to 1928 was used by the government to make preliminary surveys and studies, under the State Planning Commission (Gosplan) created in 1921, which were necessary as a basis for inaugurating a program of planned production and distribution for the country as a whole. With the inception of the First Five-year Plan for industrialization of the basically agricultural Soviet economy, private

trade was restricted more and more, while the remnants of the former propertied classes were "liquidated." Then began the intensive drive toward achieving state socialism in Soviet Russia. But it has developed as an authoritarian socialism, with strong centralized governmental control over all phases of economic activity, and not the type of democratic socialism envisaged by liberal socialists. However, the Soviet economy, as it has evolved under the several Five-year Plans, is based on Marxian principles of socialist (not communist) production and distribution, as outlined in the preceding chapter.

37–3. Socialist Production. Since, according to Marxian doctrine, socialism will develop out of capitalism through the dictatorship of the proletariat, the leaders of the Soviet government have set about to create the economic prerequisites of a socialized economy. This has necessitated, in particular, the rapid industrialization of the Soviet Union, and the development of the advanced production techniques of capitalist countries. The motives behind the industrialization drive under the several Five-year Plans were both political and economic. They aimed at achieving national security and national defense against threats of mechanized attack, particularly by Nazi Germany, as well as at improving the national well-being of the Soviet masses.

The capitalistic method of production implies the creation and use of capital goods by the process of saving and investing. But this should not be confused with capitalism, which is based on private ownership of capital. Although the Soviet Union, in its planned program of socialist development, has adopted the techniques of production evolved under capitalism, the industries of the country are neither privately owned nor operated for private profit. With minor exceptions, private ownership of capital goods has been abolished in the Soviet Union.

When the First Five-year Plan was begun in 1928, the country, as previously noted, was still primarily agricultural. The Russian peasants were highly individualistic, pursuing their traditional methods of strip farming on small land holdings. Many peasants had come into possession of land at the time of the revolution. In general, peasants were secure in their possession of land so long as they put it to productive use. But they were not permitted either to sell or to lease their holdings to others. Private ownership in land, as previously indicated, was also abolished in Russia at the time of the October Revolution in 1917.

The primitive methods of farming small parcels of land by individual peasants militated against the use of modern agricultural machinery in the cultivation of the soil. Mechanization of agriculture sought to increase the per-acre crop yield and so to release a portion of the peasants' labor force for industrial employment. Small-scale farming also tended to perpetuate an individualistic spirit among the peasants, in the face of the conscious

effort of the Soviet government to break down class barriers between industrial and agricultural workers, and to create a socialized order of society.

Consequently, in the early thirties, shortly after the inception of the First Five-year Plan, agricultural production in the Soviet Union was also reorganized along socialistic lines. An intensive drive was begun by the government to create cooperative collective farms, by inducing individual peasants to pool their separate land holdings into large collective units, which could be cultivated with modern agricultural machinery. Moreover, many large state farms were organized to serve as experimental units for the development of the most advanced techniques of agricultural production.

The compulsory reorganization of agriculture into collective farms invited both active and passive resistance from many peasants referred to as "kulaks."[1] Kulaks were those peasants who had acquired some possessions, such as a horse or two cows, under the comparative economic freedom enjoyed for the duration of the New Economic Policy, and who opposed the collectivization of their property. But their opposition to collectivization was ruthlessly crushed by the government; and the kulaks, as a class, were "liquidated" by execution or deportation. Eventually, the government was able to demonstrate the superiority of collective agriculture over individualistic agricultural production methods, but at an untold cost in human suffering.

With the development of collectivized agriculture, millions of peasants also left the land to find work in new Soviet industries growing up in various parts of the Soviet Union under the several Five-year Plans. As collectivized agriculture improved, the food shortage that had existed in the earlier years of agricultural reorganization, and which had required food rationing throughout the country since 1929, was gradually overcome. By 1935 the Soviet government was able to abolish rationing of most basic foodstuffs, and in 1936 rationing of consumers' goods, in general, was discontinued. But rationing of consumers' goods was reintroduced in the Soviet economy shortly after the Nazi invasion in 1941; it was continued even beyond the duration of the war, until peacetime production of consumers' goods could be sufficiently expanded to make derationing feasible.

37-4. Distribution of Income under Socialism. The directives to production in the Soviet Union are laid down in its socioeconomic plan. Expenditures to induce the planned volume of production are carefully budgeted in advance, and prices of products are fixed by governmental agencies to cover planned outlays and a margin of markup, in the form of a turnover tax. The turnover tax is thus analogous to a monopoly profit

[1] Literally, *kulak* means a fist, and was a term applied derisively to any thrifty, prosperous peasants.

accruing to the government, and is available for further investment according to plan. It has represented the primary source of budgetary revenue of the Soviet government. In 1941 it amounted to 63.2 per cent of the national budget receipts of the Soviet Union. But its relative importance declined during the war because of restricted internal trade.

Wages are paid to different classes of workers on a sliding scale. They are intended to measure roughly the productive contribution of individual workers. A certain degree of competition for the services of labor among managers of industrial units of individual plants has served as an indicator of the importance attached to individual workers, relative to their abundance or scarcity. Thus a basis has been provided for wage differentials in the Soviet Union, approximating differences in both quantity and quality of output. Piece rates, rather than time rates, have been widely adopted, particularly under the several Five-year Plans, while incentive wages in the form of bonuses play an important role in the Soviet wage structure. Wage scales ranged from 1 to 20 in 1940. But what the wages will buy, *i.e.*, the share of real income going to wage earners, depends not only on the money wages received but also on the prices of consumers' goods, fixed by the government.

Wage payments in the Soviet Union are thus basically established in accordance with the socialist principle of distribution according to quantity and quality of work performed and not, as under pure communism, according to need. Deed, rather than need, is emphasized in the prevailing distribution of income in Soviet Russia.

37–5. Markets and Prices. Prior to the abolition of food rationing in the Soviet Union in 1935, workers were able to purchase a limited supply of foodstuffs and items of clothing at governmentally fixed prices, in cooperative stores, of which they were members. These cooperatives were of two classes, namely, consumers' cooperatives and closed cooperatives. The closed cooperatives were limited in membership to workers in a particular industrial plant, or state farm, while consumers' cooperatives included workers in a variety of occupations in their membership. But only accredited members were permitted to buy their rationed supplies at governmentally fixed prices of rationed goods.

Prices were so established as to make available to the lowest wage-earning group a supply of consumption goods considered to be adequate for sustenance. But those who received a differential money wage were not permitted to purchase more than their rationed supplies in the cooperatives. They thus had money to spend, but apparently no legitimate place to spend it, a situation very similar to that which prevailed under rationing and price control in the United States during the Second World War. In order to acquire some item of use with their excess spending power, abnormally high prices were offered for available foodstuffs in peasant mar-

kets. Hence, so-called speculative peasant markets developed in the Soviet Union.

In order to curb this speculative market activity as far as possible, and at the same time to encourage systematic buying in governmental distributing units, an increasing number of retail stores were established throughout the Soviet Union; they were called commercial or state stores. Consumers' goods were placed on sale in these stores by the government, but at higher prices than those prevailing for similar goods in the cooperatives. Thus a large differential money wage was converted into a small differential real wage. But in order to gradually make the money differential, which was intended to stimulate productive efficiency, a corresponding real differential, prices were progressively lowered in commercial stores as labor productivity increased. With the abolition of rationing in 1935–1936, cooperative store prices were raised slightly until they reached the decreasing commercial store prices, and wages of the lower categories of wage earners were raised to compensate for the higher cooperative store prices.

The resultant unitary price system, which showed price differentials for various items in different parts of the Soviet Union, differing mainly by an amount equal to transportation costs, continued until rationing and a multiple price system were reintroduced in 1941.

37–6. Capital Formation in the Soviet Union. Through its control over the selling prices of consumers' goods, as we have seen, the Soviet government is able to regulate, according to plan, the size of the capital fund to be used for investment purposes. The rate of capital formation in the Soviet Union, in other words, is not left to voluntary savings of individuals, although a certain amount of saving has been carried on by individual workers. It is difficult to determine in how far such "voluntary" saving of funds was induced by the fact that, in the past, many workers earned surplus rubles, which they could not spend because of scarcity of consumers' goods.

The abolition of rationing during the years preceding the invasion of the Soviet Union in 1941 stimulated civilian consumption, but did not necessarily reduce the planned volume of saving and investment. Through its control over prices of consumers' goods, relative to wages paid to labor, the government could divert any requisite portion of the national product into expansion of its planned capital formation. In other words, by adding to individual cost prices of consumers' goods an amount that would equal the planned volume of money savings, the government could mobilize as it saw fit the resources of the people for further investment. If, for instance, total wages paid out during a period of time equaled 100 billion rubles, of which wage fund it was planned to save and invest 30 billion rubles, it would merely be necessary to raise the aggregate prices of consumers' goods, which cost 70 billion rubles to produce, to 100 billion rubles,

to realize a 30 billion ruble profit or turnover tax, for further investment according to plan. "There appears no particular reason for resorting to direct taxation and issuing loans, when popular consumption can be equally well restrained by raising prices, but no doubt there are psychological considerations which make the government unwilling to let these methods of raising revenue fall into abeyance." [1] Consequently a certain amount of borrowing of the savings of the people, in addition to both income and turnover taxes, has been resorted to by the Soviet government to meet its investment requirements. But voluntary saving plays a minor role in capital formation in the Soviet Union.

37–7. Ideal of Economic Equality. The Soviet Union, as we have seen, is developing its socialized economy, based on rewarding individual initiative according to an approximate measure of productivity. But, as Lenin has expressed it, distribution according to deed, rather than need, is formal, but not real equality. Ultimately, it has been maintained by Soviet spokesmen, socialism will lead to a higher order in society, where, because of man's scientific progress and achievements, material scarcity will be largely overcome. The development of atomic energy for peacetime pursuits points to further harnessing of the forces of nature, with a view to overcoming material scarcity of consumption goods. As relative abundance is created, so that man's basic needs may be easily satisfied, according to Marxian interpretation, the communist commonwealth will evolve out of socialism, where class differences will no longer exist, the political state will wither away, and the competitive struggle will yield to voluntary cooperation among producers and consumers. How much time will elapse before this higher phase of communism will be achieved in Soviet Russia, or as a matter of fact, anywhere else in the world, cannot be foretold. For the time being there appears to be less concern over the attainment of ideal communism anywhere among Soviet leaders than among utopian idealists in other lands.

The building of socialism is the avowed objective of the Soviet Union. Article 4 of the Soviet constitution of 1936 states explicitly that "the socialist system of economy and the socialist ownership of the means and instruments of production . . . constitute the economic foundation of the U.S.S.R.," [2] while Article 12 reiterates that "the principle applied in the U.S.S.R. is that of socialism: 'From each according to his ability, to each according to his work.' " This is in close conformity with the Marxian evolutionary doctrine, as interpreted by Lenin and his disciples.

37–8. Administrative Features of the Soviet Constitution of 1936. Although the economic foundation of the Soviet Union, according to this

[1] Hubbard, L. E., "Soviet Money and Finance," p. 191, Macmillan & Co., Ltd., London, 1936.

[2] U.S.S.R. is an abbreviation of Union of Soviet Socialist Republics.

constitution, consists of the collective ownership of the means of production, private ownership of income from work and voluntary savings, as well as household and personal effects, is protected by law. Work is the duty of every able-bodied citizen according to the principle, "He who does not work, neither shall he eat."

a. Central Governmental Functions. The jurisdiction of the Federal state (U.S.S.R.) extends to external trade, national economic planning, taxation, and the administration of all important financial, industrial, agricultural, and commercial enterprises. It includes also jurisdiction over the monetary system, transportation and communication, social insurance, education, public health, and basic labor legislation. The 1944 amendment to the Soviet constitution of 1936 gives to each of the 16 Union republics the right to enter into direct relations with foreign states, to make treaties, to exchange diplomatic representatives and to form their own military organization. This was interpreted by some critics as a strategic move by the Soviet Union to increase its voting strength in the postwar world organization. It is significant that the central government continues its right to establish the general character of the foreign relations of the Union republics and the guiding principles governing their military organization.[1]

b. Civil Rights and Liberties in the Soviet Union. The constitution of 1936 guarantees to every citizen the right to work as well as the right to planned leisure in the form of vacations with pay, admission to sanitariums, rest homes, etc. Moreover, the benefits of an elaborate system of social security, including old-age pensions and sick benefits, accrue to all citizens, regardless of sex. Women are accorded equal rights with men in all fields of economic, cultural, social, and political life. Citizenship rights are extended to all persons 18 years of age or over, regardless of race or nationality. Both freedom of religion and freedom of antireligious propaganda are recognized for all citizens. They are also assured the right to an education. Moreover, with certain qualifications set forth below, citizens are guaranteed freedom of speech, freedom of the press, and freedom of assembly. They are also guaranteed inviolability of person as well as of homes, while privacy of correspondence is protected by law. Universal military service is provided for in the constitution.

c. Critical Observations on the Soviet Constitution. Although the constitution of 1936 theoretically represents a forward step toward what may be viewed as political liberalism and away from dictatorship, certain factors should not be overlooked in its evaluation. Even under the present constitution, the Soviet government is essentially a one-party government. Citizens are assured the right to unite in public organizations for economic, cultural, technical, and scientific purposes. But they may not legally organize political opposition to the Communist party, which party,

[1] Constitution of the U.S.S.R. (1936), Art. 14 as amended.

as previously indicated, is said to unite the most active and politically conscious citizens from among the working class and other strata of the toilers.[1] It has been facetiously remarked that any number of political parties may exist in the Soviet Union, so long as the Communist party is in power and the others in jail.

Under the one-party system prevailing in the Soviet Union, the constitutional guarantee of universal, equal, and direct suffrage by secret ballot has been viewed by its critics as a legalized fiction. The rule of the majority in passing legislation is recognized in the Soviet constitution. Moreover, candidates for elective public office may be nominated by trade unions, cooperatives, youth organizations, and cultural societies, as well as by Communist party organizations. But organized political opposition to the Communist party is prohibited.

Furthermore, the preamble to the rights of freedom of speech, the press, assembly, etc., reads,[2] "In order to strengthen the socialist system." This lends itself to various interpretations, often reflecting the bias of the interpreter. It may be construed to mean that these various civil liberties are essential to strengthening the socialist system. On the other hand it may also be interpreted to mean that the freedoms are allowed only in so far as they serve to strengthen the socialist system. Thus any adverse criticism of the socialist system that might tend to weaken it would not be tolerated in the Soviet Union, according to the latter interpretation. This does not conform to the concept of civil liberties under constitutional government as understood in a capitalistic democracy. Regardless of how critically one may interpret and evaluate the basic provisions of the Soviet constitution of 1936, they point significantly toward greater human rights and civil liberties of the Soviet masses than they enjoyed, particularly under the rigorous discipline of the First Five-year Plan. During the Second World War a setback was given to the prewar trend toward increasing personal freedom in the Soviet Union, but in all probability that trend will be extended into the period of peacetime economic reconstruction and development. Mutually beneficial economic collaboration between the Soviet Union and the outside world can aid in this development. The brief description of the Soviet economy given in the preceding pages should prove helpful in providing a factual basis for such collaboration.

37–9. Economic Relations between the Soviet Union and Capitalistic Countries. The Soviet economy is essentially a "closed" economy. That does not mean that it has no economic relations with the outside world, but rather that the internal value of its currency, the ruble, bears no significant value relationship to currencies of other countries. To be sure, when the ruble was reestablished in Soviet Russia in 1922, after a period of hyper-

[1] Art. 126.
[2] Art. 125.

inflation, it was said to be secured by precious metals, primarily gold. But as there is no legal foreign exchange market for the Russian ruble, it is meaningless to translate internal ruble costs and prices into money costs and prices prevailing in capitalistic countries.

Furthermore, as we have seen, Soviet international trade is organized as a state monopoly. Trade between private traders abroad and private individuals in the Soviet Union is illegal. Although the Soviet state trading organizations may quote export prices in rubles at an "official" rate of exchange, actual payment for exports is required to be made in foreign currencies, and not in rubles. Moreover, Soviet imports are paid for with foreign exchange, and not with rubles.

The Soviet state monopoly of foreign trade makes possible planning production and internal prices, without the danger of imports disrupting the production and price programs. Internal price levels, rates of foreign exchange, and movements of gold do not affect Soviet external trade policy, as they do capitalistic economies. The requirements of the general economic plan determine the nature and extent of Soviet exports and imports. Because of the need for integrating her international trade with the internal developmental plan of the Soviet economy, effective governmental control over such trade is essential. Hence the state monopoly of external trade in the Soviet Union, which has existed since the days of the October Revolution of 1917.

37–10. Soviet Attitude toward International Trade. The attitude toward international trade of the Soviet government differs significantly from that commonly prevailing in capitalist countries. The Soviet government, in its international commercial relations, places primary emphasis on imports rather than on exports in planning its international trade program. Soviet spokesmen measure the gains from such trade in terms of what they buy, rather than in terms of what they have to sell by way of making payments. The mercantilistic bias in favor of an export balance, which still exists in capitalistic economies, does not accord with Soviet foreign trade ideology. The Soviet Union will not export any more of her internal resources than is necessary to pay for her planned imports. "Exports are considered solely as a means of paying for imports." [1] This attitude toward trade, whether internal or external, is economically sound, irrespective of the prevailing economic system in the trading countries. As has been stated previously, nations, even as individuals, gain as buyers rather than as sellers, in the exchange of goods.

37–11. Fear of Russian "Dumping." The man on the street commonly identifies dumping with selling foreign goods in domestic markets at prices ruinously low to home competitors. It is the basis of the popular argu-

[1] Budish, J. M., and S. S. Shipman, "Soviet Foreign Trade Menace or Promise," p. 7, Liveright Publishing Corp., New York, 1931.

ment against permitting the importation of "cheap" foreign products. It is an implied admission of the competitive weakness of domestic producers of such imports. This argument lacks validity, particularly in so far as importation of Russian goods is concerned. As indicated above, the Soviet Union will export no more of her relatively scarce resources in the foreseeable future than is necessary to provide the foreign exchange to pay for her imports. It is to her interest to get the best possible price, rather than to sell at a low price.

Nor is there much likelihood that Soviet Russia will "dump" domestically unsalable "surpluses" on world markets below their production costs, as has at times been practiced by private producers in capitalist countries, even with governmental support. The domestic market of Soviet Russia is not confronted with bothersome surpluses that might lead to such dumping.

The external trade monopoly of the Soviet Union permits underselling foreign competitors, if the government so decrees. Political as well as economic considerations must be weighed in evaluating such Soviet external trade policies. The question here is not so much one of whether or not the governmental international trade monopoly could be used to injure foreign competitors, as it is whether or not it would be so employed for political reasons. It may indeed be used to acquire foreign exchange if liberal postwar short-term, as well as long-term, credits were first extended to the Soviet Union for reconstruction and development, and then debt service charges, as well as debt repayment, were to fall due during another world economic depression, such as that of the thirties. Under these circumstances the Soviet government might have to revise its external trade plans and increase the physical volume of exports at reduced prices, in order to obtain the requisite foreign exchange to meet its obligations. This might lead to charges of ruinous "dumping," designed to injure foreign competitors and induce import restrictions in various countries. Yet any such selling of Russian goods could hardly be viewed as deliberate Soviet policy, seeking to ruin foreign competitors and to disrupt foreign markets. The real disruptive factors would rather have to be sought in the economic instability in capitalist countries.

The contention that the Soviet Union might sell abroad below domestic costs of production and thereby subsidize its exports, is based on fallacious conjecture. A simple illustration will help to clarify the point at issue. Let us assume that the "official" rate of exchange between the Russian ruble and the American dollar has been set at 20 cents. A bushel of Russian wheat of standard grade selling in world markets for $1 would have an official ruble value equivalent of 5 rubles. If, now, it cost 25 internal rubles to produce this bushel of wheat, it would appear as though the wheat were being sold abroad at one-fifth of its domestic money costs of production.

(Transportation costs have not been taken into account, since they do not affect the validity of the illustration.) But if the Soviet government could purchase with the dollar derived from the sale of the bushel of wheat a machine tool that would cost 30 rubles to produce in Russia, she will obviously have gained by these transactions. Since in the Soviet economy purchases and sales are correlated according to plan, the sale of Russian goods abroad in terms of arbitrary ruble prices, far below internal money costs, may still result in a net economic gain, when properly related to the completed exchange of goods for goods. This gain arises from the application of the principles of territorial division of labor and comparative costs. But such selling cannot properly be viewed as "dumping" in the sense of selling below costs of production.

While cost accounting is stressed in the planned economy of Soviet Russia, cost items do not necessarily coincide with those of private enterprises in a capitalistic society. "In practice the Soviet administration includes interest on capital and charges for natural resources in its cost accounting,"[1] as well as labor and material costs. On the other hand, such items as insurance, transportation, and marketing expenses are not included in cost calculations of separate Soviet concerns. But irrespective of where money costs are accounted for in the Soviet economy, they are largely administered prices rather than open-market prices. Thus while the chief components of cost in a private enterprise economy also enter into Soviet cost accounting, they cannot be compared quantitatively with cost prices established in open markets. The similarities between stated cost items in planned cost accounting in Soviet Russia and in private concerns in capitalist countries give no indication as to their relative weights, which may differ greatly in the two economic systems. Therefore the "dumping" charge cannot logically be based on the "differences in costs of production" argument.

"The truth is that when Russia conducts normal profitable trade it looks as if she were dumping, as long as the ruble is over-valued [externally]: that it is extremely difficult to apply our economic and legal concepts of dumping to Russia; and that to prove or disprove dumping in the individual case is next to impossible."[2]

37–12. Multilateral Trade between the Soviet Union and the Outside World. Not until the political skies between Soviet Russia and western powers have cleared, and the many misapprehensions concerning the Soviet foreign trade monopoly have been removed, will it be possible to develop healthy commercial relations between Soviet Russia and the outside world. While it is the general aim of the Soviet planned economy to

[1] LANGE, OSCAR, Marxian Economics in the Soviet Union, *American Economic Review*, vol. 35, No. 1, p. 133, Mar., 1945.

[2] GERSCHENKRON, ALEXANDER, "Economic Relations with the U.S.S.R.," p. 47, Committee on International Economic Policies, New York, 1945.

balance trade, wherever possible, with individual countries, as is indicated in the bilateral trade agreements entered into since the close of the Second World War, the Soviet government has also shown its willingness to enter into trade agreements wherever the best credit terms are available. Possibly for political reasons, she has not seen fit to join the International Monetary Fund and the International Bank for Reconstruction and Development, although she participated actively in the Bretton Woods Monetary Conference. Yet her negotiation for substantial long-term credits in various foreign countries, including the United States, shortly after the close of the Second World War, suggested her desire to expand her international commercial relationships.

Nor can the Soviet Union be viewed as an excessive credit risk by foreign creditors. She established an enviable record in the interwar period in meeting contractual obligations on international commercial account. At a time when defaulting on international debts of various types was widely practiced, the Soviet government met all its international commercial obligations faithfully. Recognition of this record should help to strengthen the basis of expanding multilateral trade between the Soviet Union and the rest of the world.

Admittedly the methods of conducting international trade between capitalistic economies in open markets on the one hand, and between a planned socialized closed economy and capitalistic economies on the other hand, differ in many respects. Special trade agreements between the Soviet government and various foreign countries, as have been drawn up in the past, can, however, provide equality of trading opportunity by guaranteeing most-favored nation treatment to the contracting countries; and, if considered expedient, they can also be made to include nondiscriminatory quantitative safeguards.

A major economic problem confronting the postwar world is to construct the contractual framework within which mutually beneficial trade among all the nations of the world, whether capitalistic, socialistic, or "communistic," may be developed. The different institutional backgrounds and the divergent ideologies on which the various economic systems rest do not preclude economic intercourse among them. The proposals for expansion of world trade and employment, developed in 1945 in the United States State Department for the International Conference on Trade and Employment, "reflect awareness that we live in a world of many countries with a variety of economic systems. They seek to make it possible for those systems to meet in the market place without conflict, thus to contribute each to the other's prosperity and welfare. In no case do they impinge on sovereign independence, but they do recognize that measures adopted by any one country may have effect abroad and they suggest for general adoption fair rules of mutual tolerance."

While the problem of developing sound commercial relations between

the Soviet Union and the United States can hardly be solved overnight, its very challenging nature should make us want to find a mutually satisfactory solution. Two countries as different as the United States and Soviet Russia can develop mutually advantageous trade relations, even as they have in the past, under the conditions so succinctly set forth by the British economist, G. D. H. Cole:

> There must be currency arrangements which allow balances to be settled; there must be reasonable confidence that neither intends deliberately to bilk the other by default and there must be a firm abstention on both sides from any attempt to use trade as an instrument for forcing the other country to alter its economic system. Given these three conditions, the difference of system presents no real obstacle to trade on any scale that may be desired.[1]

Of the many economic problems of modern life surveyed in the preceding pages, that of developing sound economic relations between two such basically different economic systems as that of the Soviet Union and the United States is of paramount importance. Its successful solution, based on mutual understanding and tolerance, will contribute immeasurably toward achieving and maintaining world prosperity and world peace.

Guide Questions on Text

1. "During the Second World War our governmentally directed economy showed many similarities with the working principles of the Soviet economic system." Explain and illustrate.
2. Do you consider the Soviet economy a threat to the institutions of capitalism? Give reasons for your viewpoint.
3. The Soviet system is often characterized as communism. Criticize this characterization.
4. What, according to Lenin, are the several stages in the transition from capitalism to communism? In which of the stages is the Soviet Union? Give reasons.
5. What evidence is there that the Soviet Union is interested in developing multilateral postwar international trade?
6. Interpret the expression "dictatorship of the proletariat," as applied in the Soviet Union.
7. What were the reasons for and characteristics of the New Economic Policy adopted in 1921?
8. Point out the significant features of socialist production, as contrasted with capitalist production.
9. Explain the reasons for the collectivization of agriculture in the Soviet Union.
10. How is income distributed in the Soviet Union?
11. Trace the development of markets and the pricing process under the several Five-year Plans.
12. "Through its control over prices, the Soviet government can divert any requisite portion of the national product into planned capital formation." Explain and give illustrations.

[1] As quoted in *The New York Times*, Magazine, Oct. 13, 1946, p. 10.

13. It has been said that there is "formal" but not "real" equality in the Soviet Union. Do you agree? Reasons.

14. Analyze the chief provisions of the Soviet constitution of 1936 as to social and economic functions of the Soviet government.

15. Evaluate critically the basic civil liberties guaranteed under the Soviet constitution.

16. What is meant by a "closed" economy?

17. How does the fact that the Soviet economy is "closed" affect its economic relations with the outside world?

18. Evaluate the Soviet attitude toward international trade, especially dumping.

19. Point out the differences between the items of cost entering into "socialistic cost accounting" and those pertaining to "cost accounting" of a capitalistic enterprise.

Topics for Investigation

1. Setting of prices in the Soviet economy.
2. Comparative study of the functions of labor organizations in the Soviet Union and in the United States.
3. With what can Russia pay for proposed increasing imports?
4. Prerequisites and objectives of socioeconomic planning in Soviet Russia.
5. The development of civil liberties in Soviet Russia.
6. Aims and objectives of postwar economic policy of the Soviet Union.

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